Understanding Margin and its Risks

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Before opening a margin account, you should have a clear understanding of the basic facts about margin and the risks of trading securities on margin. To help you gain that understanding, Siebert has prepared the following margin education program in the form of a Q&A. We encourage you to read it carefully and call us if you have any questions.[1]

Basic Facts About Margin

1. How does a margin account differ from a cash account?

The two basic types of brokerage accounts are cash accounts and margin accounts. In a cash account, you are required to pay in cash the full purchase price of a security at the time you purchase it. In a margin account, you can pay part of the purchase price with money that you borrow from your brokerage firm using the securities and other assets in your account(s) as collateral for the loan.

2. What types of transactions involve margin?

Margin transactions are those that involve the brokerage firm extending credit to you. When you purchase securities, you can pay for those securities in full when due, in which case your brokerage firm is not deemed to have extended credit to you. If you choose to borrow funds from your brokerage firm to pay part of the purchase price, you will be purchasing the securities in a credit transaction "on margin."

Other transactions involving the extension of margin credit to you include (a) borrowing money from your brokerage firm, using the securities already in your account(s) as collateral, (b) selling securities short and (c) writing put and call options.

3. Are there different types of margin requirements?

Yes, there are different types of margin requirements, and the amount of margin required to satisfy them may vary based on the rules and regulations of the Federal Reserve Board, self-regulatory organizations like FINRA, and your brokerage firm's own "house" requirements. Margin requirements include:

<u>Minimum Margin</u>

Before you can trade on margin, current regulations require you to deposit in a margin account with your brokerage firm the lesser of (1) a minimum of $2,000 and (2) 100% percent of the price of the securities you propose to purchase. Your brokerage firm may require a higher minimum deposit.

Initial Margin

Normally, you may borrow up to 50% of the price of the securities you propose to purchase on margin. This means that you must deposit 50% of the purchase price, with the other 50% loaned to you by your brokerage firm. This loan is called the "initial margin." Keep in mind that not all securities may be purchased on margin and that the initial margin requirement may be higher than 50%.

Maintenance Margin

Once you have purchased a security on margin, you will be required to maintain a minimum amount of "equity" in your margin account. "Equity" is the market value of securities in your account minus the amount you owe your brokerage firm, which includes the amount outstanding on your margin loan. This is called "maintenance margin." Regulations currently require maintenance margin of at least 25%; however, many brokerage firms require higher maintenance margin depending on factors such as the history of your account, the type of securities in the account and market conditions. You should be aware that your brokerage firm may increase maintenance margin requirements at any time.

4. May I use a margin loan for a purpose other than purchasing, carrying or trading securities in my margin account?

Yes. Using the assets in your margin account as collateral, you may be able to borrow funds for other purposes, such as paying college tuition or medical expenses, or making a down payment on a house. Given the risks of margin (discussed below) and the complexity of tax laws, you should obtain the advice of your own financial and tax advisors if you are considering a margin loan for such purposes.

5. What securities are "marginable"?

Margin credit may be extended to a customer in a margin account against securities collateral consisting only of those securities that are margin-eligible. Generally, this includes U.S. government issued and government guaranteed securities, municipal securities and any security registered or having unlisted trading privileges on a national securities exchange such as the NYSE and Nasdaq. Securities quoted in Nasdaq's OTC Bulletin Board are not marginable.

6. Must I sign a margin agreement to open a margin account?

Yes, brokerage firms normally require customers to sign a margin agreement before being permitted to trade on margin. This is a very important document that sets forth the terms and conditions that will govern your margin account. For example, it explains the use of your securities and other assets in your account(s) as collateral for your loan, how the interest on your loan is calculated, the right of your brokerage firm to use your securities in its business (including loaning out or "hypothecating" your securities to third-parties), and the fact that you may be required on short notice to provide additional collateral and, if you fail to do so, that your brokerage firm has the right to sell some or all of the securities and other assets in your account(s), without advance notice to you. **BEFORE SIGNING ANY MARGIN AGREEMENT, YOU SHOULD REVIEW IT VERY CAREFULLY AND BE SURE YOU UNDERSTAND IT.**

7. What determines the interest rate charged to my account on my margin loan?

As with most loans, you are required to pay interest on the amount you borrow in your margin account until the loan is repaid. The rate of interest is typically set by a formula based on a reference rate such as the published rate for brokers' call money. The margin rate moves up and down in relation to changes in the underlying reference rate. The rate is subject to change without notice to reflect changes in the reference rate. The amount of interest charged to your account is typically computed monthly on the average debit balance in your margin account during the month.

These interest deductions, along with the interest rate charged to your account, normally appear on your monthly account statement. If the rate changes during the month, a separate charge is typically broken out for each interest period with a different rate. You should review your account statements carefully to stay informed of the rate and amount of interest you are paying for your margin loan. Interest expense on a margin loan can materially reduce the rate of return on your investment.

8. Are the margin rates charged by my brokerage firm negotiable?

Some brokerage firms may be willing to negotiate with individual customers interest rates on margin loans based on such factors as the amount of the average debit balance in your account(s), the firm's experience with the account(s) and the quality of the collateral in the account(s). You should contact your brokerage firm directly for further information.

Risks of Margin Trading

Margin accounts are not suitable for everyone. Trading on margin can expose an investor to substantial risks. This includes the risk of losing more money than you invested. Consequently, you need to understand the risks of margin before you buy a security on margin.

1. Why is a margin loan risky?

Margin enables you to increase your "buying power" by borrowing money to purchase securities instead of having to pay in cash the full amount of the purchase price. If the stock goes up, the rate of return on your investment may be substantially higher than if you had paid the full purchase price in cash. Conversely, however, the leverage involved in a margin loan means that if the stock goes down, you can incur substantial losses very quickly. If the price declines, you may be required to come up with additional margin on very short notice in the form of cash or securities to satisfy margin maintenance requirements. In addition, if there is a margin deficiency in your account (that is, the equity in your account is not enough to meet the maintenance margin requirement), you face the risk of your brokerage firm selling the securities and other assets in your account(s) to satisfy the deficiency. These sales may be made without any advance notice to you.

2. What is a “margin call”?

A “margin call” is a demand made to you by your brokerage firm to deposit more money or marginable securities in your margin account as collateral for your margin loan. It is triggered when the equity in the account falls below the minimum maintenance margin requirement. The most common reason is an adverse movement in the price of one or more securities positions in the account, which serve as collateral for the margin loan. A margin deficiency resulting in a margin call may also be caused by your brokerage firm or a regulator increasing maintenance margin requirements.

3. What action can a brokerage firm take if the equity in my margin account falls below the firm’s minimum maintenance margin requirement?

In order to cover a margin deficiency, the brokerage firm usually can force the sale of securities or other assets in your margin account and your other accounts (if any) with the firm. Your margin agreement should set forth the rights of your brokerage firm in dealing with a margin deficiency.

4. Must my brokerage firm notify me before taking such action by issuing a margin call or otherwise?

No. While a brokerage firm normally will attempt to notify a customer of a margin call, it is not required to do so before selling securities or other assets to cover a margin deficiency. Further, even when you have been given notice of a margin call and the specific date by which it must be met, the firm normally can decide to take action to protect its financial interest prior to that date. This may include selling all or part of the securities or other assets in your account(s) without giving you prior notice.

5. What if the proceeds from the sale of the securities or other asset(s) in my account(s) are not sufficient to fully cover the margin deficiency?

In accordance with the margin agreement, you typically remain personally liable for any such shortfall, as well as for any cost incurred by your brokerage firm in collecting that amount.

6. In the event that I do not timely deposit sufficient additional cash or securities in response to a margin call, may I decide which securities or other assets in my account(s) will be sold to meet the margin deficiency?

No. To protect its financial interest, your brokerage firm typically has the right to determine which collateral for the margin loan to liquidate and in what order. This may well mean that securities or other assets are sold for your account(s) that you would not have chosen. Further, such sales may result in adverse and untimely tax consequences to you.

7. If I receive a margin call, do I have a right to an extension of time to meet it?

No, you have no “right” to an extension of time. Even if one is made available to you, your brokerage firm normally reserves the right to protect its interests by immediately liquidating collateral in your account(s) without prior notice to you in the event of changing circumstances, such as a continuing decline in the price or liquidity of some or all of the collateral for your margin loan.

8. How does a short sale involve margin?

When you sell short, you are selling a stock that you do not own. In order to make delivery on the sale, you need to borrow the security. A short sale is deemed to involve an extension of credit by your brokerage firm to you. This is because the firm is either loaning the security to you or borrowing the security on your behalf in order to let you make delivery. As a result, you become obligated to the firm to eventually return the borrowed security and "cover" the open short position.

9. How much margin is required to sell short?

In general, the margin required on the short sale of an equity security is 150% of its current market value. This is normally satisfied by the brokerage firm retaining all (100%) of the net proceeds of the short sale and the customer depositing the balance (the additional 50%).

10. What are the risks of margin in selling short?

Short selling is a margin account transaction that involves all of the same risks of margin described above. For example, an upward price movement in the security sold short may result in a margin deficiency in your account. Normally, your brokerage firm has the right, without first contacting you, to buy securities in your account to cover a short position. It may use or liquidate all or any portion of the asset(s) in your account(s) to generate the funds needed to pay for that purchase. If those assets are not sufficient, you typically will be responsible for any shortfall, as well as the costs incurred by your firm in collecting that shortfall.

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1. Siebert presents this as a general education piece on margin. The specific practices and policies of Siebert or any other brokerage firm may vary from the descriptions in this piece. Consequently, you should refer to the specific agreements, disclosure statements and other documents that govern your relationship with your brokerage firm. If your brokerage firm executes and clears customer transactions through another broker-dealer, your margin agreement may be with one or both firms.