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Using this study guide.

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

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Introduction

If an investor pays the full purchase price of his trade within five full business days of the trade date, the account is a cash account. If an investor uses credit to buy securities, the account is a margin account. Regulation T of the Securities Exchange Act of 1934 governs both types of accounts. The trade date is the day the order is executed either on an exchange or over-the-counter. The dealer/broker must cancel the trade if the payment is not made within the five full business days. If the customer paid only part of the money due and owes more than \$1,000 by the end of the fifth day, the unpaid part will be sold. If less than \$1,000 is due, the dealer/broker may use his own judgment and give his client more time if he wishes.

If the dealer/broker cancels the trade or liquidates the unpaid part, the customer's cash account is frozen for 90 calendar days and he must pay cash for any new trades. Cash accounts may be frozen in this way, but margin accounts are never frozen.

A customer may request an extension of the five business days if he has justifiable reasons. A national securities exchange, the National Association of Securities Dealers or a Federal Reserve Bank may approve the request for an extension.

Regulation T of the Securities Exchange Act of 1934 governs the use of credit by brokerage firms to finance securities transactions. It gave the Federal Reserve Board the power to establish standards for margin accounts. The Board decides which securities may be purchased on margin and denotes the applicable percentage of down payment required. The required percentage (known as the Reg. T percentage) has been 50% since January of 1974.

Loans must be secured or collateralized before a brokerage firm can lend any money to a client. Clients may pledge stocks in order to obtain financing for the account. This is known as hypothecation. In turn, the firm may pledge the same stock to obtain loans from banks. This is known as re-hypothecation and helps the firm to afford carrying margin accounts for their clients. The maximum legal amount of a customer's securities that may be

re-hypothecated for the purpose of carrying customer margin accounts is 140%.

Securities are registered in the brokerage firm's name (or its nominee) so that the loan collateral may be liquidated quickly. This is referred to as the "street name." Even though the stock has the firm's name as its street name, the customer maintains actual ownership and receives all the benefits such as dividends, interest, capital appreciation, voting rights, pre-emptive rights and the right to sell out the position and liquidate the account in whole or in part.

If the brokerage firm combines a customer's securities with its own in order to obtain loans and other benefits beyond the fair and reasonable practices allowable in the law, the practice is illegal and is called commingling.

If a client buys 100 shares at \$75 per share in a margin account with Reg. T at 50%, the initial margin call is 50% of $100 \times \$75$ or $.50 \times \$7,500 = \$3,750$. That is, the client must deposit \$3,750 in his margin account within the Reg. T time limit of five business days. The current market value (CMV) of the security is \$7,500, the loan from the broker (debit balance) is \$3,750 and the equity (amount owned minus amount owed) is \$3,750. Also, the loan value of the account is \$3,750 and is the maximum loan available at the current market value. Loan value percentage plus Reg. T percentage will always add up to 100%.

If a customer does not have cash available to meet the initial margin call, he may use securities he owns outright instead. Since Reg. T is 50%, the broker may give the client a loan of 50% of their CMV. The client may deposit the securities into his account, get a loan of 50% of CMV, and use these funds to meet the initial margin call. As an example, a \$10,000 purchase would need a cash deposit of \$5,000. Or the client must deposit marginable securities with a loan value of \$5,000. The broker/dealer will loan \$5,000 if the client deposits securities he owns outright with a CMV of \$10,000 (the current market value of securities in lieu of cash is the Reg. T percentage divided by the loan percentage times the purchase).

Excess Equity and Buying Power

Even when the market value of the stock changes in the marketplace, the debit balance stays the same. Since the debit does not change, the equity increases the same amount as the current market value. That is, if the CMV of the stock in the previous example increased from \$10,000 to \$11,000, the equity increased by \$1,000. Since the broker/dealer could loan \$5,500 (Reg. T of 50% times \$11,000), but the client has only borrowed \$5,000, there is \$500 worth of additional borrowing power available to the client if he wants to use it. The \$500 is referred to as excess equity or SMA, special memorandum account. The calculation for SMA is loan value less debit balance equals excess equity.

When a client has excess equity, he may choose to borrow it in cash thereby removing it from his account, use it to purchase more stock, or reserve the right to borrow or use it at a later time.

If the client chooses to borrow the excess equity in cash, he asks the cashier to forward him a check for \$500 and his new debit balance will be \$5,500. He is really borrowing the money because an increase in the market value of the account gave the stock more collateral and its loan value or SMA increases. Removing the SMA increases the debit balance.

If the client chooses to buy more stock, the excess equity can offset the cost of the margin call. Since he has \$500 of excess equity, he has \$1,000 of buying power (\$500 divided by the 50% Reg. T = \$1,000). That is, if the customer places an order to buy \$1,000 worth of stock on margin, he would have no additional out-of-pocket expenses. He simply tells his broker to use the \$500 excess equity to cover the margin call for the \$1,000 additional stock.

If the client chooses to reserve the right to borrow or use the excess equity at a later time, the brokerage firm usually makes a written record of the amount of the excess at the time it is created by the rising market value. The broker will make a written entry in a supplementary margin account called the Special Memorandum Account (SMA). If a cash dividend is received on stock held in a margin account, the customer has the choice of taking the dividend out of the account or leaving it in. If he leaves it in, the

cash is used to reduce the debit balance and the SMA is increased by that amount. That is, if a client in a margin account gets a cash dividend of \$500 on stock held in the account, he may withdraw the \$500 in cash, he may apply the dividend against the debit balance and reduce it by \$500 or he may leave the dividend in the account and the SMA will increase by \$500.

After the excess equity is entered into the SMA, it stays there until it is used, even if the market takes a downward turn. In this way, clients are encouraged to make additional transactions. SMAs are only lost if they are used. Other names for excess equity within the industry include margin excess, Reg. T excess and additional loan value.

Restricted Accounts

If a client buys 100 shares at \$75 per share with Reg. T at 50% and the CMV drops to \$65, the debit balance remains the same and the equity decreases by \$1,000 ($\$75 - \65×100). A margin account in which the equity falls below the Reg. T percentage is a Restricted Margin Account.

Initially	After CMV drop
CMV \$7,500	CMV \$6,500
- Dr. 3,750	- Dr. 3,750
<hr/> Equity \$ 3,750	<hr/> Equity \$2,750

There are two ways to evaluate a margin account's status---with numerical form and percentage form. For numerical form, Reg. T required equity less the actual equity determines the amount by which the account is restricted. In the above case, the figures are $\$3,250 (50\% \times \$6,500) - \$2,750 = \500 . For percentage form, a comparison is made of the Reg. T requirement to the equity %. In the above case, the calculations are $\$2750$ (equity) divided by $\$6,500$ (CMV) = 42% which is less than the Reg. T of 50%. With both the numerical and the percentage form, the account is clearly restricted because there is less than \$3,250 equity and the % is 42% instead of 50%.

Having a restricted account does not restrict a client who wants to buy additional securities as long as he deposits the Reg. T percentage on each new purchase, just as with a non-restricted account. Any client who wants to liquidate some of his holdings in a restricted margin account will learn that the Retention Rule of the Federal Reserve is applicable. The Retention Rule dictates that the brokerage firm retains 50% of the sale proceeds and uses this amount to reduce the client's debit balance. The other 50% may be used by the customer as he wishes. He may choose to take it in cash, buy more stock or leave it in the account for future use.

In the above example, if the customer decides to sell 10 of his shares at \$65 per share, his liquidation proceeds will be 10 X \$65 or \$650; the retention by his broker will be 50% X \$650 or \$325; the amount available to the client will be \$650 - \$325 or \$325. The account now looks like this:

CMV	\$5,850	(\$6,500 - \$650)
- Dr.	<u>3,425</u>	<u>(\$3,750 - \$325)</u>
Equity	\$5,425	

If a client fails to meet an initial margin call under Reg. T in an existing margin account, the firm must sell securities in the account in an amount equal to twice the margin call. In such a case, the account would not be frozen because only cash accounts are frozen.

For a restricted account, the normal industry procedure is that all dividends and interest received are automatically subtracted from the journal of the margin account and added into the SMA on the day received.

Same-Day Substitution

Same-day substitution refers to the netting of a purchase and sale of different securities in a client's restricted margin account on the same day. The determination of any margin call due or proceeds due is made at the end of the day by the firm involved. For a net buy, the Reg. T times the net buy equals the margin call. For a net sale, the retention % times the net sale equals the retention by the broker (with the balance going to the customer).

If Mr. Jones makes a same day substitution in a restricted margin account by selling \$6,000 of DEF stock and then buying \$8,000 of GHI stock, his required margin deposit would be \$1,000 if Reg. T is 50%. The net trade here is a buy of \$2,000, so $.50 \times \$2,000 = \$1,000$.

If Ms. Blue makes a same day substitution in her restricted margin account by selling \$4,000 of ABC stock and then buying \$3,000 of XYZ stock, her broker must retain \$500 if Reg. T is 50% and Retention is 50%. The net trade in this case is a sell of \$1,000. The dealer/broker must keep 50% of the net proceeds or \$500. Ms. Blue may withdraw the other \$500 or journal it into her SMA.

Non-Restricted Accounts

If a client's equity is the same as the Reg. T percentage, a sale of securities in the account releases proceeds to the client equal to the Reg. T percentage.

\$5,000 CMV	Sell \$1,000 worth of stock
<u>-2,500 Dr.</u>	\$1,000 X 50% = \$500 to client
\$2,500 Equity	\$1,000 X 50% = \$500 retained
(Reg. T = 50%)	by broker to reduce Dr.

After this transaction the account shows:

\$4,000 CMV
<u>- 2,000 Dr.</u>
\$2,000 which is 50% of \$4,000
and equity is still Reg. T

Minimum Maintenance Requirement

SRO rules require clients to maintain at all times an equity of at least 25% of the market value of the security in a margin account. This is referred

to as the Minimum Maintenance Requirement and becomes especially important for clients and brokers when the CMV is declining. When the market value drops, the client's equity drops by the exact amount of the change in CMV.

Initially	After CMV drop
CMV \$7,500	CMV \$4,500
- Dr. <u>3,750</u>	- Dr. <u>3,750</u>
Equity \$ 3,750	Equity \$ 750

The NYSE/NASD minimum equity requirement of this account is 25% of \$4,500 or \$1,125. Since there is only \$750 in equity, the account is deficient \$1,125 - \$750 or \$375. This account is called an undermargined account because its equity is less than the NYSE/NASD minimum maintenance requirement. Rules of the NYSE/NASD demand that the equity must be increased to the 25% minimum immediately. The client will be issued a maintenance margin call for the deficient \$375. The \$375 is applied to the debit balance, thereby increasing the equity. (With CMV \$4,500 and Dr. \$4,125, the equity will increase to \$1,125.)

To determine how low an account market value can fall before the account would be at the maintenance level, multiply the client's debit balance by 4/3. With the above debit balance of \$3,750, the market value down to which the account may drop is $\$3,750 \times \frac{4}{3} = \$5,000$. This means that if the stock drops from the original \$75 to \$50 per share, the equity in the account will have dropped to the NYSE minimum level of 25%.

\$5,000	CMV
- <u>3,750</u>	Dr.
\$1,250	which is 25% of \$5,000

If Mr. Brown buys 100 shares of KJL at \$140 per share and Reg. T is 50%, the stock can go down to \$ 93 per share before he will be asked to make an additional deposit to meet the 25% maintenance requirement. When Mr. Brown bought the \$14,000 of stock, the initial margin call was \$7,000 (50% of the \$14,000) leaving a debit balance of \$7,000. $4/3 \times \$7,000 = \$9,333 / 100 = \$93.33$.

NYSE/NASD Minimum Credit Requirement

This rule establishes that brokerage firms may not arrange credit for any customer unless his margin account has equity of at least \$2,000. This rule applies at all times, but is especially applicable to initial transactions in newly opened margin accounts.

If Reg. T is 50% and Mr. Green buys 150 shares at \$15 in a new margin account, his margin call would be \$2,000. The Reg. T would require only \$1,125 but this is \$875 less than the minimum. The client must deposit \$2,000.

With Reg. T at 50%, if Ms. Grimms buys 50 shares at \$20 per share in a new margin account, her margin call is \$1,000. \$2,000 would exceed the total purchase price and is too much. Loans cannot be given unless the equity is at least \$2,000. In this case, no loan would be issued; Ms. Grimms would simply pay in full 100% of the purchase price or \$1,000.

To re-cap: A client never pays more than his total purchase price. A client may be given loans under Reg. T only if his account has an equity of at least \$2,000. The \$2,000 is not a maintenance level. It is just the level below which no credit may be given to customers. If a decrease in the CMV of an account lowers the equity to less than \$2,000, there is no requirement to increase it to the \$2,000 figure. A client may not withdraw an amount of money that will drop his equity below \$2,000 or bring his equity below the maintenance level.

The Federal Reserve regulates Regulation T's payment time requirements, the Retention Rule, and the marginability of listed stocks, OTC margin stocks and bonds, the NASDAQ National Market System, and convertible bonds. NYSE/NASD regulates maintenance and the minimum credit requirements.

The Short Sale

Investors who expect a market decline may sell borrowed shares of stock at current market price, return the shares to the lender when the price has dropped and profit from the “short” sale. This is basically the buy low-sell high philosophy in reverse. The short seller borrows property (shares of stock), not money for this exchange. Because of the high degree of risk involved, this is permitted only in a margin account. The client must show his financial ability to buy back the property by having a Reg. T call as good faith. With a short sale, market fluctuations influence equity in various ways.

Credit Balance and Equity

If Mr. Green sells short 100 shares of XYZ at \$50 per share with Reg. T at 50%, his margin account will be credited with the sale proceeds of \$5,000 even though Mr. Green would have no access to this money at this time. The account will also be credited with Mr. Green’s required Reg. T margin call of $\$5,000 \times 50\%$ or \$2,500. The credit balance in Mr. Green’s margin account is \$7,500 (the sum of the proceeds of the short sale and the Reg. T margin call). This \$7,500 will not change regardless of market changes in the future. The credit balance in a short margin account is permanent, but the cost of buying back the borrowed stock to cover the short sale and the equity in the account can change.

Mr. Green’s equity in this account is the difference between his credit balance (\$7,500) and the current market value (\$5,000) or \$2,500. If the stock prices increase to \$60 per share, the equity drops to \$1,500 ($\$7,500 - \$6,000$) and the equity no longer meets the Reg. T requirement. The account will be restricted by $(\$6,000 \times 50\%) - \$1,500$ or \$1,500 and its equity percentage is now \$1,500 divided by \$6,000 or 25%. That is, as the market value of the shorted stock increases, the equity decreases and as the market value decreases, the equity increases. Any change in market value causes a dollar for dollar change in equity.

Minimum Maintenance Requirement for Short Sales

If the market value increases to \$75 per share, the equity drops all the way to zero. Because the market price could potentially increase to infinity and the maximum potential loss on a short sale is unlimited, SROs have set the minimum maintenance for a short margin account at an equity of 30% of the CMV. In Mr. Green’s case, when the CMV rose to \$75 per share, the minimum equity that must be maintained under SRO rules would be \$7,500 X 30% or \$2,250. Mr. Green would receive a \$2,250 maintenance call to bring his equity up to that amount.

There is no requirement to keep a margin account up to Reg. T equity. The maintenance equity of 30% is the level up to which the account must be brought when its equity drops below 30%.

Excess Equity (SMA) and Buying Power

If Mr. Green’s stock dropped to \$40 per share, his account would look like this:

Cr.	\$ 7,500
- CMV	\$ 4,000
Equity	\$3,500

This is higher than the \$2,500 Reg. T and SMA. Excess equity has been established in the amount of \$1,500 [actual equity of \$3,500 – Reg. T equity of \$2,000 (50% of \$4,000 CMV) = excess equity of \$1,500]. This SMA may be used to buy more securities or as the Reg. T down payment for another short sale which would be called shorting power or selling power. SMA divided by Reg. T = shorting power. In this example, \$1,500 / 50% = \$3,000 of buying power. A short sale’s margin call is the same as for a long purchase.

Cheap Stock Rule

SROs have established special maintenance rules in short margin accounts to guard against the unreasonable risk in low-priced issues. These rules are called the “cheap stock” rules.

A customer must **always** maintain an equity in a short margin account of the greater of these:

- A. 30% of the CMV which is the SRO Maintenance Requirement.
- B. \$2,000 which is the SRO Minimum Credit Requirement.
- C. The equity required in these “cheap stock” rules:

<u>Stock Price</u>	<u>Minimum Equity that must be Maintained</u>
0 to \$2½ per share	\$2½ per share
\$2½ to \$5 per share	100% of per share price
\$5 per share & up	\$5 per share

For example, if Ms. Brown shorts 1200 shares of GHI stock at \$2 per share, her initial deposit and maintenance requirement would be calculated as follows: Reg. T will not be applicable until the equity is \$2,000 or more, so the SRO minimum credit requirement of \$2,000 would be applicable. But, because this is “cheap stock”, the special rules may require more than \$2,000. Since the above chart shows \$2½ per share as the minimum equity to be maintained, Ms. Brown must keep 1200 X \$2½ or \$3,000. That is, to comply with SRO rules, Ms. Brown must maintain at least \$3,000 in this account at all times. Also, should the market begin to rise, the cheap stock rules dictate that the amount of money in the account must be at least 100% of the price per share until the price hits \$5. In this case, if the stock rose to \$3 per share, Ms. Brown would have to have at least \$3,600 in the account.

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Now that you have completed reading this course, you may proceed to the accompanying exam to earn a verifiable certificate of completion.