

Low-Priced Equity Securities

Guidance on Low-Priced Equity Securities in Customer Margin and Firm Proprietary Accounts

Executive Summary

This *Notice* provides guidance to firms on low-priced equity securities in customer margin and firm proprietary accounts.

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Background & Discussion

Price volatility is more often associated with low-priced, rather than higher-priced, equity securities. Low-priced equity securities tend to trade with bid and ask spreads that make up a greater percentage of the security's price. This is especially true for newer companies whose stock is priced low and whose earnings may be more volatile. In addition, due to lower volumes, low-priced equity securities can experience large price swings during a given trading day, which translates into greater price risk. Further, low-priced equity securities may be removed from an index, which can increase the volatility and exacerbate the price risk.

In a strategy-based margin account, the current maintenance margin requirement for any long equity security is generally 25 percent of the current market value,¹ and generally 30 percent of the current market value for any short equity security.² In a portfolio margin account, the current maintenance margin requirement for both long and short eligible equity securities is determined by the Options Clearing Corporation's TIMS stress range of +/- 15 percent.³

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Notice Type

- ▶ Special Alert

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Margin Department
- ▶ Operations
- ▶ Regulatory Reporting
- ▶ Risk Management
- ▶ Senior Management

Key Topics

- ▶ Low-Priced Equity Securities
- ▶ Margin
- ▶ Net Capital

Referenced Rules & Notices

- ▶ FINRA Rule 4210
- ▶ Regulatory Notice 09-53
- ▶ Regulatory Notice 09-65
- ▶ SEA Rule 15c3-1

Firms are reminded to consider the risks associated with low-priced equity securities when extending credit in a strategy-based or portfolio margin account. Firms should take into account volatility and concentrated positions in a single customer account and across all customer accounts, as well as the daily volume and market capitalization of each security when imposing “house” maintenance margin requirements.⁴ Firms should also consider the fundamental business drivers and financial performance of the issuer in setting house requirements. Increased maintenance margin requirements can help to ensure that the equity in each customer account is sufficient to cover any large variances in the price of a security. FINRA believes that a best practice is for firms to pay close attention to low-priced equity securities when considering the dollar amount of credit to be extended to any one customer.⁵ Similarly, in a portfolio margin account, FINRA believes that a best practice is for firms to subject low-priced or concentrated positions to heightened review and daily monitoring, subjected to higher margin requirements, where appropriate, and to include such positions in exception reporting to senior management.⁶

Firms are also reminded that, pursuant to SEA Rule 15c3-1, if markets can absorb only a limited number of shares of a security for which a ready market exists (a marketplace blockage), the non-marketable portion in the proprietary or other accounts of a broker-dealer is subject to a 100 percent deduction to net capital, and is treated as a non-allowable asset.⁷

Endnotes

- 1 See FINRA Rule 4210(c). FINRA prescribes higher maintenance margin requirements for leveraged exchange-traded funds (ETFs) and uncovered options overlying leveraged ETFs. See *Regulatory Notices 09-53 and 09-65*.
- 2 FINRA Rule 4210(c) prescribes a maintenance margin requirement of \$2.50 per share or 100 percent of the current market value, whichever is greater, for each short stock priced at less than \$5.00 per share; and \$5.00 per share or 30 percent of the current market value, whichever is greater, for each short stock priced at \$5.00 per share or greater.
- 3 See FINRA Rule 4210(g). TIMS stands for Theoretical Intermarket Margin System.
- 4 See FINRA Rule 4210(f)(1) and its associated Interpretation /01 for concentrated or volatile securities (providing, among other things, that substantial additional margin must be required: (1) when there are concentrations in single securities (either in particular accounts or in all margin accounts carried) which, due to their size, may not be liquidated promptly; and (2) for accounts with positions in volatile securities subject to unusually rapid or violent changes in value. Accordingly, steps should be taken to increase margin requirements when it appears that accumulated positions will be difficult to liquidate promptly; and prevent such positions from being acquired).

- 5 See FINRA Rule 4210(d) and its associated Interpretation /01 (requiring, among other things, that members determine the total dollar amount of credit to be extended to any one customer or on any one security to limit the potential loss or exposure to the member. It is important that specific limits be established to prevent any one customer or group of customers from endangering the member's capital).
- 6 See FINRA Rule 4210(g)(1)(I) and its associated Interpretation /01 (requiring, among other things, member firms to have procedures that describe the identification and monitoring of concentrated positions within individual portfolio margin accounts and across all portfolio margin accounts, including what department is responsible for the daily monitoring of such positions, what the escalation procedures are, and a detailed description of what additional margin requirements, if any, are applied to concentrated positions).
- 7 See Interpretation /01 of SEA Rule 15c3-1(c)(2)(vii). In an October 5, 1987, letter from the Division of Trading and Markets, the Division provided guidance for determining which portion of a particular position is considered non-marketable when a broker-dealer is confronted with a marketplace blockage. The Division indicated that it would recommend no action to the SEC if a broker-dealer, when faced with a blockage in securities, treats as readily marketable securities that portion of the block which equals the aggregate of the most recent four-week, inter-dealer trading volume. The number of shares exceeding this amount should be considered non-marketable and subject to a 100 percent deduction from net capital, and is treated as a non-allowable asset, unless the broker-dealer can demonstrate to its Designated Examining Authority that a ready market exists for the excess shares. The shares purchased by the broker-dealer during the most recent four-week period are to be excluded when determining trading volume.