SEC SECURITIES AND EXCHANGE COMMISSION OF SRI LANKA

MARGIN TRADING

A Guide to understanding Margin Trading

WORLD INVESTOR WEEK 2022

UNDERSTANDING MARGIN ACCOUNTS

Margin Trading is defined as purchasing listed securities using credit facilities obtained from a licensed Margin Provider. The investor pledges his listed securities to the lender to obtain credit upto 50% of the market value of the securities share portfolio pledged.

To obtain a Margin Trading facility, the investor has to fill up a Margin Trading account opening form and provide required documents asked by the Margin Provider such as Statement of Portfolio, Statement of Accounts, a copy of NIC/Passport etc. along with it. Once the Margin Provider assesses the credit worthiness of the investor and accepts the application, the investor could sign a Margin Trading agreement, providing an undertaking from the stock brokering firm pledging the investor's securities portfolio (Margin securities) to the lender. The Margin Trading agreement is a tri-partite agreement between the lender (Margin Provider), investor (Borrower) and the stock brokering firm.

The Margin Providers shall open a slash account with the Central Depository in respect of all its clients, through which all transactions relating to the marginable securities will be conducted. A Margin provider shall ensure that the slash accounts shall be operated by the Stock Brokers, only on the specific instructions of the Margin Provider.

Margin increases the purchasing power without having to invest any additional capital, but also exposes the investor to the potential for losses. Here's what you need to know about margin.

UNDERSTAND HOW MARGIN WORKS

In General the Margin Provider will email Margin Trading account balances daily before trading starts to the Investors at his/her request and to the Stock Brokering Firm directly, so that it is not possible to over-purchase in the Online Trading system.

Let's say you buy a share for Rs. 50 and the price of the stock rises to Rs. 75. If you bought the shares with cash and paid for it in full, you'll earn a 50 percent return on your investment (i.e., your Rs. 25 gain is 50% of your initial investment of Rs.50). But if you bought the stock on margin paying Rs.25 in cash and borrowing Rs.25 from the margin provider, you'll earn a 100% return on the money you invested (i.e., your Rs. 25 gain is 100% of your initial investment of Rs.25).[1]

The downside to using margin is that if the share price decreases, substantial losses can mount quickly. For example, let's say the share you bought for Rs. 50 falls to Rs.15. If you fully paid for the stock, you would lose 70% of your money. However, if you bought on margin, you would lose more than 100% of your money. In addition to the 100% loss of your Rs.25 initial investment, you would also owe your margin provider an additional Rs.10 plus the interest on the margin loan.

A minimum Maintenance Margin of 30% or any other percentage as decided by the Securities and Exchange Commission from time to time, has to be maintained at all times in the form of cash and/or marginable securities.

A margin provider shall make a margin call when the value of the marginable securities in the slash account fall below the maintenance margin requirement.

In the event the investor fails to respond within three (3) market days of the margin call, the margin provider shall recover the Maintenance Margin outstanding by force selling the marginable securities in the slash account through a written request to the stock brokering firm.

[1]For simplicity, this example does not account for the interest you would owe your broker on the Rs.25 margin loan you used to buy this stock. After paying this interest to your broker, your actual return would be slightly less than 100%.

RECOGNIZE THE RISKS

Margin accounts can be risky and they are not appropriate for everyone. Before opening a margin account, you should fully understand that:

- You can lose more money than you have invested;
- You may have to deposit additional cash or securities in your account on short notice to cover market losses;
- You may be forced to sell some or all of your securities when falling stock prices reduce the value of your securities;
- Your margin provider may force sell some or all of your securities without consulting you if you are unable to meet their prior Margin Calls within 3 Market Days;
- You are not entitled to choose which securities are sold in your account to cover your margin loan;
- You are not entitled to an extension of time on a margin call.

You can protect yourself

- In order to mitigate risks, have self-control and have a single stock limit of 30% of your portfolio and purchase below the maintenance Margin %.
- Knowing how a margin account works and what happens if the price of the securities purchased on margin declines.
- Understanding that you are charged interest for borrowing money and how that will affect the total return on your investments.

- Being aware that not all securities can be purchased on margin.
- Determine whether trading on margin is appropriate for you in light of your financial resources, investment objectives, and tolerance for risk.

Read Your Margin Agreement

A Margin Trading Agreement is a tripartite written agreement containing all the terms and conditions agreed by and between the Client, Margin Provider and the Stock Broker prior to carrying out any business for and on behalf of a Client.

The agreement shall contain amongst others the terms as communicated by the Securities and Exchange Commission from time to time.

A Margin Provider is required to ensure that the agreement entered into is in a language mutually agreed upon by the parties. The subsequent amendments to the agreement, if any, should be mutually agreed upon by the parties and must be in writing

KNOW THE MARGIN RULES

The Securities and Exchange Commission of Sri Lanka have rules that govern margin trading.

The minimum Maintenance Margin of thirty per centum (30%) or any other percentage as decided by the Commission from time to time, shall be maintained at all times in the form of cash and/or Marginable Securities.

The initial margin permitted to its Clients on share purchases does not exceed fifty per centum (50%) of cash value of the marginable securities portfolio of the Clients.

Here's an example of how maintenance requirements work. Let's say you purchase Rs.16,000 worth of securities by borrowing Rs.8,000 from your Margin Provider and paying Rs. 8,000 in cash or securities.

If the market value of the securities you purchased drops to Rs.12,000, the equity in your account will fall to Rs.4,000 (Rs.12,000 – Rs.8,000 = Rs.4,000). If your Margin Provider has a 30% maintenance requirement, you must have Rs.3,600 in equity in your account (30 percent of Rs.12,000 = Rs.3,600).

In this case, you do have enough equity because the Rs. 4,000 in equity in your account is greater than the Rs. 3,600 maintenance requirement.

SPECIAL CONSIDERATIONS FOR MARGIN ACCOUNTS

UNDERSTAND MARGIN CALLS – You Can Lose Your Money Fast and With No Notice

If your account falls below the Margin Provider's maintenance requirement, your Margin Provider generally will make a margin call to ask you to deposit more cash or securities into your account. When a margin call occurs you generally cannot purchase any additional securities in your account until you satisfy the margin call requirements. If you are unable to meet the margin call, your Margin Provider will sell your securities to increase the equity in your account up to or above the Margin provider's maintenance requirement.

INTEREST CHARGES –

Money is not free

Like all loans, margin loans charge interest. This interest directly reduces your return on investments, increasing the amount your investment needs to earn to break even.
Remember to carefully consider this expense before opening any margin account.

Account Transfers

If you plan to transfer securities from a margin account make sure you understand the rules for transferring securities out of these accounts. Many firms will not allow you to transfer any securities out of a margin account if the account has an outstanding margin loan.

CLIENT- Margin Provider dispute resolution

Any dispute between the Client and the Margin Provider with regard to terms and conditions set out in the tripartite agreement as the case may be, shall be resolved in accordance with the provisions set out in the Margin Trading agreement pertaining to dispute resolution.

In the event any dispute has been resolved in a court of law or by an arbitration tribunal as the case may be, a copy of the final order/judgment of court/arbitrator's award shall be submitted to the Commission by the Margin Provider immediately upon receiving such judgement/order/award.

KEY QUESTIONS YOU SHOULD CONSIDER BEFORE BUYING SECURITIES IN A MARGIN ACCOUNT

- Do you know that margin accounts involve a great deal more risk than cash accounts where you fully pay for the securities you purchase?
- Are you aware you may lose more than the amount of money you initially invested when buying on margin?
- Can you afford to lose more money than the amount you have invested?
- Did you take the time to read and understand the margin agreement?
- Did you ask questions about how a margin account works and whether it's appropriate for you to trade on margin?
- Did your margin provider explain the terms and conditions of the margin agreement?
- Are you aware of the costs you will be charged on money you borrow and how these costs affect your overall return?
- Are you aware that your margin provider can sell your securities, without notice to you if you neglected/failed to adhere to their prior Margin Calls or when you don't have sufficient equity in your margin account?

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