

## RealMoney Investment & Trading Ideas



### How Leveraged ETFs Flout Margin Requirements

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When I first met Jim Cramer in the early part of this decade, I introduced myself as an expert on the subject of Regulation T, which is a **Federal Reserve** regulation that covers the extension of credit by brokers and dealers to market participants and establishes margin requirements. Typically, Reg T is managed by the operations division within broker-dealers, but I brought the concept to the trading desk.

As the head of the equity swap desk at Merrill Lynch, I created an entire business that was based on increasing leverage to hedge funds and accredited investors. I worked closely with in-house and external attorneys who further had direct lines with securities and banking regulators. Everything was transacted within the letter of the law. I even butted heads with Long Term Capital Management and was the only person on Wall Street who stood up to them. That is a story better told over cocktails, which I did with Jim many years ago.

In addition to Regulation T, two other Federal Reserve regulations come into play:

- Regulation U deals with credit by banks and persons other than brokers or dealers for the purpose of purchasing or carrying margin stock.
- Regulation X deals with borrowers of securities credit. Reg X applies the provisions of Regulations T and U to borrowers who are subject to U.S. laws and who obtain credit within or outside the U.S. for the purpose of purchasing securities.

The enforcement of these regulations is controlled by brokers and dealers through trading accounts. Before you buy securities on credit, you should understand a number of aspects of the margin rules. Here are some definitions applied to the context of stocks:

- **Cash account:** An account in which all securities are paid for in cash and no extension of credit has been made by the broker-dealer to the customer.
- **Margin account:** An account in which securities have or can be pledged to a broker-dealer for a margin loan. Retirement accounts cannot be margined.
- **Margin securities:** These are securities that are eligible for extension of credit under margin agreements in margin accounts. Regulatory definitions outline the requirements for a security to be considered margin-eligible. In addition, individual broker-dealers may place even more-stringent requirements upon certain securities above the regulatory minimum. However, that will happen quite infrequently.
- **Minimum margin:** This represents the minimum amount that a broker-dealer will require a customer to deposit in order to establish a margin account.
- **Initial margin:** This is the amount of money that you may borrow for the purchase of a stock. According to Regulation T, this initial amount is 50%. Thus, if you desire to purchase 100 shares of **Goldman Sachs** (GS) at \$200 per share, of the total purchase price of \$20,000 the investor may borrow no more than \$10,000 (50% of \$20,000) at the time of purchase from the lender.
- **Margin loan:** This is sometimes referred to as a debit balance in a margin account. This is the amount of money the broker-dealer has lent to the individual in order to purchase margin securities. Margin loans are charged interest at a margin rate as determined by the broker-dealer. These rates

tend to be quite high and are huge revenue generators for those firms.

- **Equity:** This is simply the value of your securities less your outstanding loans. Put another way, it is what your account is worth.
- **Maintenance margin:** Think of this as an equivalent of the loan-to-value concept for home mortgages. The maintenance margin states the minimum equity that must be maintained in a margin account relative to the market value of the securities. Regulation T requires a 25% maintenance margin, while many broker-dealers require higher levels of maintenance margin, though few require more than 30%. Here is how you determine the maintenance sufficiency:

If market value multiplied by the maintenance margin percentage is greater than or equal to market value less margin loan, then you have sufficient equity.

If market value multiplied by the maintenance margin percentage is less than market value less margin loan, then you will be subject to a margin call.

- **Margin call:** This is a lender-issued requirement that calls on the borrower to deposit more cash or marginable securities in the margin account to satisfy the maintenance margin. If additional assets cannot be deposited, then securities must be sold. To satisfy the margin call under the margin requirement, the broker-dealer can liquidate securities without prior investor approval. In the Goldman Sachs example, if the value of those holdings fell below \$13,333, then a margin call would be made, since 25% of \$13,333 equals \$3,333, which is also equal to \$13,333 less the initial loan of \$10,000.

So how has the explosion of leveraged or "Ultra" ETFs violated these Federal Reserve regulations? Here are five glaring examples:

1. Retirement accounts are prohibited from borrowing on margin or short-selling. However, that can be accomplished by using leveraged and inverse ETFs.
2. Leveraged ETFs provide synthetic margin borrowing without the margin-call fail-safe mechanism. When you break it down, it is an extension of credit. How are we allowing people to buy a triple-long ETF such as the **Direxion Large Cap Bull 3x** (BGU) ETF, which gives you \$300 of exposure for \$100 of capital, while you could not do so for the outright purchase of a margin stock?
3. Inverse ETFs, while long-positioned in an account, are short-biased. While inverse and leveraged inverse ETFs are good hedging instruments, one has to question whether the Federal Reserve intended those to be held in cash accounts.
4. Leveraged ETFs are constructed using swaps just like those that I transacted many years ago. However, we were only permitted to transact via an offshore entity and/or with accredited investors. The average individual investor is not an accredited investor and hence would not qualify as a suitable counterparty to a swap.
5. The leveraged and inverse ETFs can be bought and even shorted in margin accounts. Thus you can get 6-to-1 or more leverage with that Direxion triple-leveraged ETF.

Here is how this has occurred:

The approval for these leveraged and inverse ETFs comes from the **Securities and Exchange Commission**. The Federal Reserve has no say in the matter when it comes to SEC approval. Also, the SEC even voted to propose [streamlining](#) the ETF approval process nearly one year ago. However, to my knowledge, no formal adoption of these rules changes has been made, though the SEC may be acting otherwise.

By using the ETF as the intermediary vehicle, which is considered to have accredited status as a registered investment company, the individual gets access to the swap market.

The exchanges, such as the **NYSE Euronext** want more transactional volume, and they have accommodated the rapid explosion of these products.

Here is what needs to be done:

The Fed should exclude leveraged and inverse-leveraged ETFs from the list of marginable securities, and these purchases should be transacted only in cash accounts.

Retirement accounts should be prohibited from using leveraged ETFs.

A cessation of approval of any leveraged ETF beyond 2 to 1. Right now we are rapidly creating 3x ETFs. While Direxion has stated that it has no plans to issue 4x and 5x ETFs, we have to be wary that Direxion or another sponsor will do so.

Formation of leveraged or inverse ETFs should require both Federal Reserve and SEC approval.

Investors need to be pre-screened and approved for leveraged and inverse ETF trading. This would be similar to what is performed for options trading. Furthermore, a disclosure document must be given to investors such as the "[Characteristics and Risks of Standardized Options](#)" which the Options Clearing Corp. delivers to all prospective option accounts.

Unfortunately, the genie is out of the bottle. It will take a huge coordinated regulatory effort to regain control over the failings of leveraged and inverse ETFs. That is not to say that it cannot be done. Right now our regulators and legislators have no motivation to take action. However, as sure as the sun rises in the east and sets in the west, all it will take is one major lawsuit, television expose or huge loss by a lawmaker or their constituents for the regulation of leveraged and inverse ETFs to move up the priority list.

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**Know What You Own:** Other leveraged funds include the **ProShares Ultra Real Estate ETF (URE)** , the **ProShares UltraShort Real Estate ETF (SRS)** , the **ProShares Ultra Financial ETF (UYG)** , the **ProShares UltraShort Financial (SKF)** , the **ProShares UltraShort FTSE/Xinhua China 25 (FXP)** , the **ProShares UltraShort QQQ (QID)** , the **ProShares UltraShort Oil & Gas (DUG)** and the **ProShares UltraShort Industrials (SIJ)**

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At the time of publication, Rothbort was long GS, although positions can change at any time.

Scott Rothbort has over 20 years of experience in the financial services industry. In 2002, Rothbort founded LakeView Asset Management, LLC, a registered investment advisor based in Millburn, N.J., which offers customized individually managed separate accounts, including proprietary long/short strategies to its high net worth clientele. He also is the founder and manager of the social networking educational Web site [TheFinanceProfessor.com](#).

Immediately prior to that, Rothbort worked at Merrill Lynch for 10 years, where he was instrumental in building the global equity derivative business and managed the global equity swap business from its inception. Rothbort previously held international assignments in Tokyo, Hong Kong and London while working for Morgan Stanley and County NatWest Securities.

Rothbort holds an MBA in finance and international business from the Stern School of Business of New York University and a BS in economics and accounting from the Wharton School of Business of the University of Pennsylvania. He is a Term Professor of Finance and the Chief Market Strategist for the Stillman School of Business of Seton Hall University.

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