REHYPOTHECATION

Hypothecation - takes place when a **brokerage firm lends money** to a customer to purchase securities. **All** margin accounts require a **Hypothecation Agreement** to be signed by the customer. In addition, a customer must receive a margin account risk disclosure document at or prior to the opening of the account.

NOTE *A customer's signature on a new account form is required to open a margin account, but not a cash account. Assume that a customer signature is not required unless the question or answer clearly states that the account is a margin account. Furthermore, there are no requirements to indicate on an order ticket whether the trade occurs in a cash account or margin account.*

The hypothecation agreement is included as part of the Margin Agreement which must also include all of the following:

1. The fact that the call loan rate and interest charges to the customer may change on a daily basis. **Therefore, the actual interest rate does not have to be specified.**
2. The method of computing interest charges (computed DAILY). If a firm changes the interest rate, margin requirement, or maintenance requirement, notification to the customer is not required.
3. The conditions for interest charges to be imposed
4. The method of determining the debit balance

Rehypothecation - takes place when a brokerage firm uses a customer's **margined securities** as **collateral** to borrow money from a bank.

THE MAXIMUM AMOUNT OF CUSTOMER **SECURITIES** THAT THE BROKERAGE FIRM CAN **REHYPOTHECATE (USE AS COLLATERAL**) IS

140% OF THE DEBIT BALANCE

EX: CMV - **DR** = EQ
40,000 - **20,000** = 20,000 **140% OF $20,000 = $28,000**

THE MAXIMUM AMOUNT OF **CASH** THAT THE BROKER-DEALER MAY **BORROW** FROM THE BANK USING THE CUSTOMER ACCOUNT AS COLLATERAL IS

100% OF THE DEBIT BALANCE

EX: In the previous example the maximum a broker-dealer may borrow is **$20,000**

How much of the margin account must be **segregated** (separated and not used by the broker-dealer)?

CMV - 140% OF THE DR

EX: CMV = $40,000 in account
140% of DR = $28,000 of which the firm can use as collateral
$12,000 is SEGREGATED (put aside for the customer)

The $12,000 in securities that must be segregated are called **excess margin securities.** Excess margin securities may not be used by the firm as collateral without the customer's written permission.

A firm may combine the margin accounts of all customers and rehypothecate all securities to obtain a loan to cover the debit balances of all customers.

All margin calculations must be made by the broker-dealer on a DAILY basis.

Cross liens – A bank may NOT use extra collateral (from the CMV going up) in customer securities to loan money to a broker-dealer. However, a bank MAY use extra collateral in firm securities to loan to a customer. The firm can only execute a cross lien if benefiting the customer. Therefore, cross liens are legal for the benefit of the customer, not the brokerage firm. The legal cross lien would give the bank a lien on FIRM securities to support CUSTOMER indebtedness.

Customer Protection Rule - SEC Rule 15c3-3- A firm must **segregate** all **excess margin securities** (CMV - 140% of DR) and **Free Credit Balances** (cash) of a customer account.

Free credit balances - SEC Rule 15c3-2 - **Cash not invested in anything** (not even money market funds)

Customers must be updated about free credit balances **quarterly** unless otherwise stated (active accounts – monthly)

Free credit balances do NOT have to be segregated if the firm discloses to the customers that free credit balances may be used by the firm but still will be paid on demand.

NOTE

The quarterly account statements do not specify if customer funds are segregated. The broker-dealer's balance sheet would disclose the segregation of free credit balances.

If a broker-dealer has used securities as collateral for a loan, and the broker-dealer sells the securities to a customer, the broker-dealer must take the securities out of its account and place the securities in a segregated account WITHIN 30 MINUTES after the opening of banking hours on the business day after the settlement date.