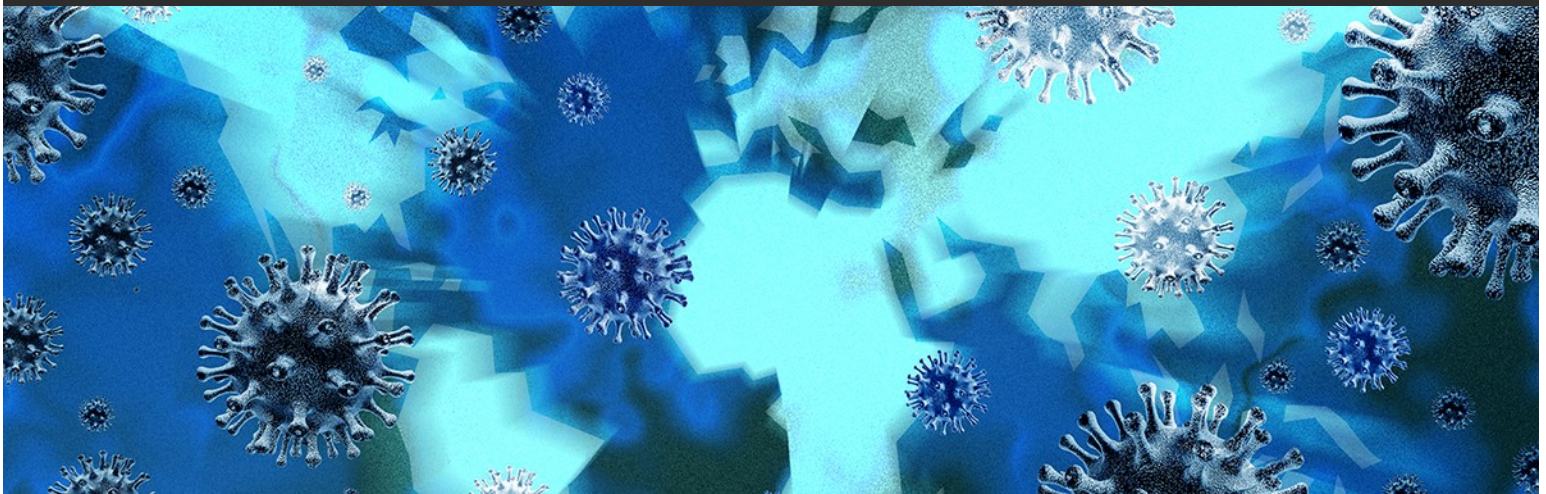


## Alert | Securities Litigation



April 2020

### Dangerous Waters: The Pitfalls of Margin Calls

What a difference a month can make. In just a few weeks, Coronavirus Disease 2019 (COVID-19) has spread quickly around the world, its effect on the American and global economies both profound yet not fully known. Now, the longest bull market in history is suddenly over. A frenzy of selling has caused sharp declines in virtually all asset classes, with a sweeping wave of margin calls and forced liquidations in the market. And as though that were not enough, brokerage firms and their professionals face the prospect of being second-guessed and possibly sued for enforcing contractual provisions that were not only essential to their decision to extend credit to customers in the first place, but also to the orderly function of the markets.

As of February 2020, FINRA reported that a total of **\$545,127,000,000 in margin balances** were outstanding (not including non-purpose loans). Many of those balances have or may experience margin calls in this turbulent market environment. While the majority of margin agreements provide firms with broad discretion and flexibility in issuing and enforcing margin calls, forced liquidations (or selective enforcement) may result in substantial litigation as well as significant business concerns. In the case of forced liquidations, customers may reach out to attorneys, who may examine the margin issues and other aspects of the customer's investments and potential losses to determine if legal claims can be asserted (including, *e.g.*, why the customer was concentrated in one security or leveraged to the degree that a call could be triggered).

Some claimants rely on fiduciary duty standards, covenants of good faith and fair dealing, and FINRA Rule 2110 requiring "high standards of commercial honor and just and equitable principles of trade" to sue based on forced sales of securities to satisfy margin calls. These claims may allege that the firm benefitted from charging margin interest and reaping increased commissions on larger trades when the market was rising but sold its customer out when the market turned sour and the firm faced the first sign

of risk from the customer's long-standing margin strategy. The claims are often asserted in FINRA arbitration, where claimants' attorneys urge arbitrators to follow equitable principles rather than apply the law, and may gain traction, especially when a firm and its employees have not been clear and consistent in its policies and communications regarding margin requirements or calls.<sup>1</sup>

For example, in these volatile times, a firm may provide a customer with a specific deadline to meet a call, but then observe a further decline in the price or credit-worthiness of the customer's collateral that requires more immediate action (such as an internal change to the amount of release the firm is willing to give on such collateral, triggering liquidation before the previously-stated deadline). Firms face potentially heightened risk when customers have previously avoided or met calls under certain margin standards that the firm later changes. Although virtually all firms have reserved for themselves the contractual right to change requirements at any time, customers have asserted claims based on their reliance on firms' prior actions or statements that they had more time to meet a call by depositing assets or selling on their own terms. These issues can be compounded when registered representatives, who often act as advocates for their customers in such times, make oral statements regarding deadlines or extensions for calls.

The issues surrounding margin calls can also raise business risks. The customers most affected by margin calls often include a firm's most sophisticated and valued relationships. These customers, and their registered representatives, may reasonably lobby for more time based on their outside assets and extensive understanding of the risks. The unique circumstances of such customers may sometimes warrant special accommodations (particularly in the case of house calls), which are perceived as necessary to preserve the relationship. The firm may have concerns about losing not only the customer, but also institutional business that the customer controls (*e.g.* in the case of senior management or high-level executives) if accommodations are not made. Such accommodations entail risks. Large customers have more to lose if the call is not enforced and the market continues to decline, possibly resulting in greater realized losses. Additionally, the disparate treatment of such customers (even when they initially requested it) may be used against the firm in subsequent litigation, whether brought by that particular customer (if the prices continue to fall and the accommodated customer loses more) or other customers (if prices rebound instead and the customers who did not get an accommodation are sold out and miss the rebound).

When addressing margin issues in the current market, it is important to anticipate the litigation and business issues that may arise. While every situation is unique and presents new or different challenges, the following actions are worth considering:

- Consider Reviewing Firm Communications Regarding Margin Requirements for Clarity and Consistency – To the extent that deadlines are conveyed, the firm may want to make the customer aware that the market is volatile, and conditions can change at any moment. To the extent that registered representatives communicate margin calls, the firm may want to provide clear guidance regarding its rights relating to margin.

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<sup>1</sup> There is a well-established body of law supporting firms' rights in connection with margin calls, including cases holding that firms can set their own deadlines for calls notwithstanding past practices so long as the deadlines are consistent with the margin agreement (*Morgan Stanley & Co. Inc. v. Peak Ridge Master SPC Ltd.*, 930 F. Supp. 2d 532, 539 (S.D.N.Y. 2013)), firms need not give customers "less drastic" alternatives to meet calls (*Capital Options Investments, Inc. v. Goldberg Bros. Commodities, Inc.*, 958 F.2d 186, 190-91 (7th Cir. 1992)), margin rules (including Regulation T) do not provide a private cause of action (*Shearson Lehman Bros., Inc. v. M & L Investments*, 10 F.3d 1510, 1516 (10th Cir. 1993)), the covenant of good faith and fair dealing cannot be used to change other express contractual terms (such as those relating to margin), (*Capital Options Investments, Inc. v. Goldberg Bros. Commodities, Inc.*, 958 F.2d 186, 190-91 (7th Cir. 1992)) and a wide range of other decisions that are helpful in this context. That said, the development of this body of law is stunted to a degree as a result of industry-wide mandatory arbitration, which does not result in precedential decisions. Moreover, many arbitrations involving tens if not hundreds of millions of dollars have been decided by arbitrators who may shirk their duties or not correctly apply the law.

- Consider Keeping Practices Consistent Regarding Margin Calls – While all customers have unique circumstances, the highly volatile nature of the current markets makes case-by-case determinations difficult, if not impossible.
- Consider Documenting How Customers Received Margin-Related Disclosures – Most firms provide detailed written disclosures to customers upon opening a margin account, and they may want to consider how they will prove delivery of such disclosures in the event of subsequent litigation. Also, when an account receives margin calls, the firm should be able to demonstrate how such calls were communicated to the customer.
- Management May Want to Consider Contacting Customers with Substantial Margin Balances – Even before margin calls arise, to the extent reasonable, firm management may consider identifying and where appropriate contacting customers with substantial leverage. Clear notes should be kept of all such contacts. Any issues should be immediately resolved with the client and the registered representative.
- Consider Advising Customers and Representatives That They May Not Have Time to Use Outside Assets to Meet Calls – It may be appropriate to communicate this express risk to margin customers utilizing margin and encourage them to bring additional assets to the firm in advance of calls if they wish to use such funds to meet future calls.
- If Possible, Give Advance Notice of Significant Changes to Margin Requirements – At times, a firm may decide to reduce or eliminate the margin terms it extends on a particular security or asset class. To the extent possible, affected customers should be given notice of a potential change before it is executed.

For more information and updates on the developing COVID-19 situation, visit [GT's Health Emergency Preparedness Task Force: Coronavirus Disease 2019](#).

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