Module 16 Article

The Risks Of Shorting A Stock

<u>Key Terms</u>

- **Margin Call**: Helps assure brokers that you will pay the position back by making you add money to your account.
- **Non-Marginable Securities**: Stocks that are not allowed to be shorted, the list of these stocks is updated on the first Monday of every month.

The 1st Risk Is Margin

Taking a short position involves selling borrowing shares for cash. This is called margin trading because you now have cash you can trade, but it's also not free. For as long as an investor holds borrowed shares, the lender charges interest on them.

If the share price increases, the investor has to both buy the shares back at a higher price and pay the interest accrued on said shares. On the flip side, if the price falls, margin trading allows for larger returns, despite the interest payments.

The 2nd Risk Is Infinite

The second, more dangerous implication of shorting is that the price of a stock can only decrease to 0, but it can increase to infinity. In essence, investors could lose an unlimited amount of money.

Protective Measures

There are several hoops short sellers must jump through, put in place to protect investors and brokers alike. Many of these measures are in relation to trading on margin. The reason that short sellers are trading on margin is that they immediately receive cash for the shares of stock they short.

With that cash, investors can then go purchase additional shares of stock, creating a situation filled with risk and leverage. That's why, to ensure that this margin capital can be paid back, FINRA requires a “maintenance margin”.

Maintenance Margin refers to the minimum equity an investor must have in their account. FINRA only requires a 25% maintenance margin, but it can be as high as 30-40%.", If the value of securities in an investor’s margin account falls below the maintenance margin, FINRA issues a margin call, requiring more money to be deposited into the account.

On Rapunzl, we require 100%, fully-funded shorts which do not provide you with additional margin cash. This is to prohibit excessive shorting and discourage poor investing practices with excessive leverage.

The Bottom Line

The risk associated with shorting is twofold: interest accrued on borrowed equity can increase quickly, however the potential for loss is endless. The Federal Reserve and FINRA have strict regulation on investors to ensure there is enough money in margin accounts.