INVESTORS CORNERED: THE RISKS OF SECURITIES-BACKED LOANS

Jason Burge[1]

Non-purpose loans,[2] or more colloquially, "securities-backed loans," are a way for investors to borrow against the securities held in an investment account, thereby obtaining liquidity without immediately liquidating the assets. Securities-backed loans became increasingly common through the 2010s, with the SEC reporting that "between 2012 and 2014, one large brokerage firm that offered these programs reported a 70 percent increase in its securities-based lending business, while another reported an over 50 percent increase."[3]

Not surprisingly, the increase in securities-backed lending led to an increase in customer complaints and arbitrations resulting from investors with securities-backed loans. A search through FINRA's Arbitration Award database for awards discussing a "credit line" shows 48 total awards, of which twenty were from 1991 through 2014 (i.e., less than one per year), but eight such awards were from the last two years alone. Likewise, FINRA's Arbitration Award database contains no awards discussing a "securities-backed loan" prior to 2019, but there have been five since then. Investor claims involving credit lines and securities-backed loans are becoming more common as these products become more popular.

As Susan Song, Regina Meng, Mike Yan, and Craig McCann note in their article in this issue "Diversifying a Concentrated Stock Position in 2023," investing on margin is generally not a suitable strategy for investors looking for long-term returns on a diversified basis. Long-term investing on margin "either increases risk or dramatically lowers the expected return of the concentrated portfolio – *or it does both*."[4] For this reason alone, investing with borrowed funds is not a suitable strategy for most investors.

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2. The Federal Reserve defines a "nonpurpose loan" as "a loan made for any purpose other than purchasing or carrying margin stock." *See* https://www.federalreserve.gov/supervisionreg/regucg.htm.

3. *See* SEC "Investor Alert: Securities-Backed Lines of Credit" (Dec. 21, 2015).

4. *See id*. (emphasis added).

An unfortunate characteristic of securities-backed lending, however, is that it is easy for an investor to fall into the trap of investing on a leveraged basis for a lengthy period of time. Securities-backed loans are generally non-amortizing, thus there is little inherent pressure to pay them back promptly. I have personally represented several investors who had securities-backed loans outstanding for years (in one case, over a decade), without any effort or even a plan to pay down the balance. That investment strategy exposes an investor to many risks of which they may not have been aware.

The Many Risks of Securities-Backed Loans

As an initial matter, although it's largely governed by Regulation U rather than the more familiar Regulation T, securities-backed loans pose most of the same risks as a traditional margin account. Brokerage firms are required to disclose the general risks of margin trading pursuant to FINRA Rule 2264. These risks include: the possibility of losing more than you invest; the firm's ability to liquidate the account; the inability to direct which securities will be sold in a forced liquidation; the firm's ability to adjust the margin requirements at any time; and that an investor is not entitled to an extension of time to respond to a margin call.[5] These risks have led some market observers to describe margin agreements as "contracts of adhesion,"[6] and make the margin loan relationship almost entirely one-sided. Given that securities-backed loans are often utilized in RIA accounts—where investors rightfully expect that their advisor owes them a fiduciary duty—the whiplash between the fiduciary obligations of an RIA and the contractual rights of a securities-backed lender will often surprise an unsuspecting investor.

But in addition to those risks that are required to be disclosed, securities-backed loans also create other risks and disadvantages that are not as well understood or publicized.

High Expense Ratios

One significant disadvantage of a securities-backed loan is that it can lead to a shockingly high expense ratio for an investment account. It is not difficult

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5. *See* FINRA, Rule 2264 (2011).

6. *See* Douglas J. Schulz, *Online/Internet Trading Gambling, BD's No Duties, Third-Party Accounts*, 30 PIABA Bar Journal 36 (2023).

to achieve an annual expense burden of upwards of 10-15% of the net asset value of an account when a significant securities-backed loan is involved.[7] There is no other product an investment bank could sell to a customer that would generate that level of expense, which in turn likely dooms the investors' account to a decline in value over any lengthy period.

Managing Investments to Maximize Collateral rather than Investment Returns

Investors also may not realize that in managed accounts, the need to maintain adequate collateral to support a securities-backed loan may affect the allocation of different types of securities in their account. Many brokerage firms maintain a collateral schedule, sometimes called a "release rate" schedule, which provides different collateral values for different types of securities. An investor may be entitled to take out a loan equal to 95% of the current market value of a municipal bond, but only 75% of the current market value of a common stock. Thus, an RIA seeking to ensure that an investors' account maintains adequate collateral to support a securities-backed loan may overweight the account in higher "release rate" securities, like municipal bonds or even cash equivalents. This lowers the expected return of the account, which when combined with the higher expense burden noted above, makes a long-term decline in account value even more likely.

Trapping Investors into a Relationship with a Broker or Investment Advisor

Another disadvantage of a securities-backed loan is that it can lock an investor into a relationship with their current brokerage firm, regardless of the performance of that firm or whether their current advisor remains employed with the firm. Unlike unencumbered investment assets, which generally can be freely transferred when a customer leaves a brokerage firm either due to dissatisfaction or the relocation of their advisor, a securities-backed loan and the assets it encumbers are not freely transferable. An investor will either have

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7. Assume an investor had $1,000,000 of investments in a managed account, paying a 1% management fee and a 55 basis point sub-account charge, as well as a $700,000 securities-backed loan with 6% interest. On an annual basis, that would be $57,500 in interest and management fees on an account with a net asset value of only $300,000, or an expense ratio of 19.2%!.

to find a new firm willing to pay for the loan, or to pay off the loan by liquidating the assets. It's not surprising, then, that one brokerage firm reported that clients with credit lines were less likely to switch firms. Securities-backed loans greatly increase the difficulty of transferring an investor's account to a new brokerage firm.

The Timing of a Margin Call

Finally, although many investors may be aware of the possibility of a margin call, the reality is that a margin deficiency on a securities-backed account is most likely to occur at a time of a market disruption or other market nadir. Because a securities-backed loan is often secured not by a single or a few margin stocks—which may not be correlated with larger market trends—but rather by a more traditional investment account which may be relatively more diversified across the market, the likeliest time for a margin call is a market disruption or market downturn when the broader markets decline. Many investors saw margin calls on their securities-backed loans in March 2020, for example, when the markets initially dipped due to concerns about the COVID-19 pandemic. A margin call at a market disruption or downturn means that an investor's securities will be liquidated to pay off the loan at the moment of their lowest value, thus locking in losses that might never be realized if the investor could hold onto the securities through the market disruption or downturn.

Long-term Securities-Backed Loans are a Terrible Strategy for Investors

This combination of risks illustrates why long-term securities-backed loans are a terrible strategy for investors: these loans generate an extremely high expense burden, incentivize more conservative investments with lower investment returns, prevent an investor from moving their funds to a different firm, and are likely to be liquidated at the worst possible time for the investor. Sometimes an investor's immediate need for short-term liquidity might outweigh these disadvantages. But when an investor has a long-term securities-backed loan encumbering an investment account, it is reasonable to ask if their advisor's interest in generating fee and interest income has overcome that advisor's fiduciary duty to ensure that their client's funds are suitably managed. In almost any scenario, an investor would be far better served by liquidating the assets, paying off the loan, and investing the net asset value on an unencumbered basis.