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Avoiding cash account trading violations

When you're trading in your cash account, it's important to understand the rules to avoid possible violations.

Before placing your first trade, you will need to decide whether you plan to trade on a cash basis or on margin. In the examples below, we will review the trading rules and violations that pertain to **cash account trading**.

As the term implies, a cash account requires that you pay for all purchases in full by the settlement date. For example, if you bought 1,000 shares of AAPL stock on Monday for $10,000, you would need to have $10,000 in cash available in your account to pay for the trade on settlement date. According to industry standards, most securities have a settlement date that occurs on trade date plus two business days (T+2). That means that if you buy a stock on a Monday, settlement date would be Wednesday. If you plan to trade strictly on a cash basis, there are three types of potential violations you should aim to avoid: **good faith violations**, **freeriding**, and **cash liquidations**.

Good faith violation

What is it?

A good faith violation occurs when you buy a security and sell it before paying for the initial purchase in full with settled funds. Only cash or the sales proceeds of fully paid for securities qualify as "settled funds."

Liquidating a position before it was ever paid for with settled funds is considered a "good faith violation" because no good faith effort was made to deposit additional cash into the account prior to settlement date. The following examples illustrate how two hypothetical traders (John and Steph) might incur good faith violations:

Good faith violation example, John:

- Cash available to trade = $0.00
- On Monday morning, John sells GME stock and nets $10,000 in cash account proceeds
- On Monday afternoon, he buys AAPL stock for $10,000

If John sells AAPL stock prior to Wednesday (the settlement date of the GME sale), the transaction would be deemed a good faith violation because AAPL stock was sold before the account had sufficient funds to fully pay for the purchase.

Good faith violation example, Steph:

- Cash available to trade = $10,000, all of which is settled
- On Monday morning, Steph buys $10,000 of GME stock
- On Monday mid-day, she sells GME stock for $10,500

At this point, Steph has not incurred a good faith violation because she had sufficient settled funds to pay for the purchase of GME stock at the time of the purchase. However:

- Near market close on Monday, Steph buys $10,500 of AAPL stock
- On Tuesday afternoon, she sells AAPL stock and incurs a good faith violation

This trade is a violation because Steph sold AAPL before Monday's sale of GME stock settled and those proceeds became available to pay for the purchase of AAPL stock

Consequences

If you incur three good faith violations in a 12-month period in a cash account, your brokerage firm will restrict your account. This means you will only be able to buy securities if you have sufficient settled cash in the account prior to placing a trade. This restriction will be effective for 90 calendar days.

Freeriding violation

What is it?

While the term "freeriding" may sound like a pleasant experience, it's anything but. A freeriding violation occurs when you buy securities and then pay for that purchase by using the proceeds from a sale of the same securities. This practice violates Regulation T of the Federal Reserve Board concerning broker-dealer credit to customers. The following examples illustrate how two hypothetical traders (Sean and Gloria) might incur freeriding violations.

Freeriding example — Sean

- Sean has $0 cash available to trade
- On Monday morning, Sean buys $10,000 of AAPL stock
- No payment is received from Sean by Wednesday's settlement date
- On Thursday, Sean sells AAPL stock for $10,500 to cover the cost of his purchase

A freeriding violation occurs because Sean did not pay for the stock in full prior to selling it.

Freeriding example — Gloria

- Gloria has $5,000 cash available to trade
- On Monday morning, she buys $10,000 of AAPL stock with the intention of sending a $5,000 payment before Wednesday through an electronic funds transfer
- On Tuesday, AAPL stock rises dramatically in value due to rumors of a takeover
- Later in the day on Tuesday, Gloria sells AAPL stock for $15,000 and decides it is no longer necessary to send the $5,000 payment

A freeriding violation occurs because the $10,000 purchase of AAPL stock was paid for, in part, with proceeds from the sale of AAPL stock.

Consequences

If you incur one freeriding violation in a 12-month period in a cash account, your brokerage firm will restrict your account. This means you will only be able to buy securities if you have sufficient settled cash in the account prior to placing a trade. This restriction will be effective for 90 calendar days. As these examples illustrate, it's easy to encounter problems if you are an active trader and don't fully understand cash account trading rules. It is important to maintain sufficient settled funds to pay for purchases in full by settlement date to help you avoid cash account restrictions.

Cash liquidation violation

What is it?

A cash liquidation violation occurs when you buy securities and cover the cost of that purchase by selling other fully paid securities after the purchase date. This is considered a violation because brokerage industry rules require you to have sufficient settled cash in your account to cover purchases on settlement date. The following example illustrates how Robin, a hypothetical trader, might incur a cash liquidation violation:

Cash liquidation violation example — Robin:

- Cash available to trade = $0.00
- On Monday, Robin buys $10,000 of AAPL stock
- On Tuesday, he sells $12,500 of GME stock to raise cash to pay for the AAPL trade that will settle on Wednesday

A cash liquidation violation will occur. Why? Because when the AAPL purchase settles on Wednesday, Robin's cash account will not have sufficient settled cash to pay for the purchase because the sale of the GME stock will not settle until Thursday.

Consequences

If you incur three cash liquidation violations in a 12-month period in a cash account, your brokerage firm will restrict your account. This means you will only be able to buy securities if you have sufficient settled cash in the account prior to placing a trade. This restriction will be effective for 90 calendar days.

For additional details please reference the following link:

https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_cashaccounts