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12 April 1991

To: The Chief Executive
All Authorised Institutions

Dear Sir/Madam

Lending to Stockbrokers

It is common practice amongst authorised institutions in Hong Kong to extend credit facilities to stockbrokers against security over shares which have been lodged with the stockbrokers by their clients.

Section 81 of the Securities Ordinance makes it clear that stockbrokers must first obtain their clients' consent if they wish to pledge the clients' shares as security. The mere fact that a broker holds such shares together with executed transfers might not be sufficient in law to establish that the broker has his client's permission to pledge the shares.

In consequence of this, there appears to be an increasing practice amongst authorised institutions, when accepting shares of clients lodged with stockbrokers as security, of relying upon the brokers signing a declaration, which usually would be on a standard form issued by the institution. This is to the effect that the broker has met the requirements of section 81 of the Securities Ordinance with respect to the shares offered as security. Typically, the declaration states that the shares pledged with the bank are owned directly by the broker or, if owned by other persons, that the broker holds valid written authorities to pledge the shares on their behalf.

We have reservations as to whether an authorised institution is entitled to assume from such a declaration that the broker indeed has valid authority to use his client's shares as security. Should the institution have need to have recourse to the collateral, it would appear that it would be necessary to prove that:

- (a) the client of the broker had consented to the use of his shares as security for the broker's own debt; and
- (b) that the consent applied to the specific shares.

We therefore strongly advise institutions to assess appropriately their credit facilities to brokers. If the security of shares of a broker's clients cannot be relied upon, the lending institution will need to make proper assessment of the creditworthiness of the broker.

Before the security of shares of a broker's clients can be fully relied upon by the lending institution, it should have sight of the actual written client authority to the broker allowing him to use the shares as security.

We are aware that in some cases an institution may find it difficult to match a client's consent with specific shares. However, the point remains that without production of the client's consent, a facility to a broker cannot be regarded as well secured. In such cases, we expect that the institution will assess the facility as general lending to the broker, taking into consideration the broker's track record and general creditworthiness, including his current and projected income flows.

Yours faithfully

Albert Cheok
Deputy Commissioner of Banking