This module should be read in conjunction with the Introduction and with the Glossary, which contains an explanation of abbreviations and other terms used in this Manual. If reading on-line, click on blue underlined headings to activate hyperlinks to the relevant module.

Purpose

To set out the minimum standards expected of AIs which are engaged in the activity of: (i) financing their clients' subscription for new shares in an IPO; (ii) performing the role of a receiving bank in an IPO; or (iii) providing share margin financing to their clients

Classification

A statutory guideline issued by the MA under the Banking Ordinance, §7(3)

Previous guidelines superseded

Guideline 5.1.2 "Financing of the Subscription of New Share Issues" dated 15.04.93;

Guideline 5.1.3 "Financing of the Subscription of New Share Issues" dated 31.05.93;

Guideline 5.1.4 "Role of the Receiving Bank in New Share Issues" dated 05.02.94;

Guideline 5.11 "Proposed Regulation on Share Margin Financing" dated 08.05.98;

Circular "Lending for the Purchase of Shares" dated 28.02.00;

Circular "Role of the Receiving Bank in New Share Issues" dated 30.05.00;

Circular "Initial Public Offering" dated 11.12.03;

Circular "Fraud cases involving stolen refund cheques in initial public offerings" dated 02.03.04; and

Circular "Enhanced security measures on refund cheques in initial public offerings" dated 22.07.04

Application

To all AIs

Structure

1. Introduction
   - 1.1 Terminology
   - 1.2 Background and scope
   - 1.3 Supervisory approach
2. Risk analysis of an IPO
   - 2.1 General
   - 2.2 Major risks to lending AIs
   - 2.3 Major risks to receiving banks
3. Risk analysis of share margin financing
   - 3.1 General
   - 3.2 Major risks to lending AIs
4. Financing subscription for new share issues
   - 4.1 Policies and procedures
   - 4.2 Prior analysis and approval
   - 4.3 Credit limits
   - 4.4 Specific lending arrangements
   - 4.5 Margin requirement
   - 4.6 Prior funding arrangements
5. Acting as receiving bank in new share issues
   - 5.1 Business strategy
   - 5.2 Role and responsibilities
   - 5.3 Initial assessment
   - 5.4 Management of application process
   - 5.5 Contingency plan
   - 5.6 Specific trust arrangements
   - 5.7 Recycling of application monies

6. Handling of IPO refund monies

6.1 Security measures for IPO refund cheques

6.2 Electronic refund for eIPO applications

7. Share margin financing

7.1 Policies and procedures

7.2 Lending principles

7.3 Credit monitoring and reporting systems

7.4 Acceptance and management of share collateral

7.5 Monitoring of collateral value

---

1. Introduction

1.1 Terminology

1.1.1 In this module, the following abbreviations and terms have the meanings set out:

- "associated entity" has the meaning set out in Schedule 1 of the SFO;
- "CAR" means capital adequacy ratio;
- "CCASS" means the Central Clearing and Settlement System;
- "eIPO" means an IPO made via the Internet or other electronic media;
- "HKEx" means The Hong Kong Exchanges and Clearing Limited;
- "IPO" means the initial public offering of a newly listed stock;
- "lending AI" means an AI which extends credit facilities to its clients for the purpose of: (i) facilitating their subscription for new shares in an IPO; (ii) financing their acquisition or holding of shares in listed stocks (in the case of lending to investors); or (iii) financing their business

operations (in the case of lending to stockbrokers);

- "licensed corporation" means a corporation which is granted a licence by the SFC under §116 or §117 of the SFO;
- "receiving bank" means a bank which performs the role of a receiving bank in an IPO. For an IPO with more than one receiving bank, the receiving bank is the main receiving bank or a sub-receiving bank, as the case may be;
- "relevant individual" has the meaning set out in §20(10) of the Banking Ordinance[1];
- "RI" means an AI which is a registered institution under the SFO;
- "RTGS" means Real Time Gross Settlement;
- "securities" have the meaning set out in Schedule 1 of the SFO;
- "securities margin financing", in relation to a person carrying on the business of securities margin financing under the SFO, has the meaning set out in Schedule 5 of the SFO[2];
- "SFC" means the Securities and Futures Commission;
- "SFC Code" means the Code of Conduct for Persons Licensed by or Registered with the SFC;
- "SFO" means the Securities and Futures Ordinance; and
- "share margin financing", in relation to a lending AI, means the provision of credit facilities by the

[1] In generic terms, a relevant individual is an individual who carries out any regulated function in a regulated activity of a RI.

[2] Broadly speaking, securities margin financing refers to the provision of financial accommodation in order to facilitate the acquisition of securities listed on a stock exchange and, where applicable, the continued holding of those securities, whether or not those or other securities are pledged as security for the accommodation, but does not include, inter alia, the provision of financial accommodation by an AI for the purpose of facilitating acquisitions or holdings of securities by the AI's clients.

AI to its clients, who may be investors or stockbrokers, whereby the facilities provided are: (i) used for financing their investments in the stock market or their business operations (in the case of stockbrokers in respect of their business of securities margin financing); (ii) collateralised by shares listed on a stock exchange (which may be located in or outside Hong Kong); and (iii) subject to margin requirements[3] prescribed by the AI.

1.1.2 The legal terms and regulatory requirements mentioned or explained in this module, particularly those pertaining to securities-related activities regulated by the SFC under the SFO, are for AIs' reference only. AIs should seek legal advice if precise interpretation is required.

1.2 Background and scope

1.2.1 As an international financial centre with close business and trading links with Mainland China, Hong Kong has seen a significant growth in its stock market activity in recent years. In particular, the listing of a number of Mainland companies on the HKEx (some of which were large new share issues with record over-subscription rates) has boosted the level of IPO activity in Hong Kong and provided AIs with more opportunities to participate in IPOs, whether as a lending AI to finance the subscription for new shares or as a receiving bank. With the marked increase in retail participation in the stock market, some AIs have also actively engaged in the business of providing share margin financing to their clients (including stockbrokers who obtain bank borrowing to finance their operations).

1.2.2 AIs which play a key part in the provision of credit and liquidity in the above-mentioned activities are required to have an adequate understanding of the potential risks

[3] The facility limit is normally expressed as a prescribed percentage of the market value of shares pledged with the lending AI. For example, a prescribed percentage of 40% means that the AI requires a lending margin of not less than 60% of the market value of the share collateral. If the required margin cannot be met due to a decline in the market value of the share collateral, the borrower will be obliged to top up the margin immediately.

that they may be exposed to and to be capable of managing those risks.

1.2.3 This module is aimed at:

- highlighting the major risks that AIs should be aware of if they are involved in new share issues as a lending AI or as a receiving bank, or in the provision of share margin financing to their clients (see sections 2 and 3); and
- specifying the minimum business and control standards expected of AIs in managing such risks (see sections 4, 5 and 7).

In addition, the preventive measures that AIs should observe in handling IPO refund cheques for their clients and the availability of electronic refund for e-IPO applications are discussed in section 6.

1.2.4 In developing this module, the HKMA has had regard to:

- the guidelines and circulars previously issued by the HKMA on new share subscription and share margin financing;
- relevant standards and requirements issued by the SFC on securities margin financing[4]; and
- current industry practices.

1.2.5 For the avoidance of doubt, this module is not applicable to AIs' subsidiaries which are licensed and regulated under the SFO.

1.2.6 AIs may wish to refer to SB-1 "Supervision of regulated activities of SFC-registered authorized institutions" on the HKMA's approach to supervising securities-related activities of AIs. See also other modules in the Supervisory Policy Manual (such as those relating to internal controls and credit risk management) that have a general application.

[4] Under the SFO, any person carrying on the business of securities margin financing is required to be licensed by the SFC, and be subject to the requirements set out in Schedule 5 of the SFC Code on securities margin financing. AIs are exempted from such requirements.

1.3 Supervisory approach

1.3.1 The HKMA has no objection in principle to AIs taking a role in an IPO, whether as a lending AI or as a receiving bank. However, AIs involved in such activity need to demonstrate their ability to conduct such activity prudently and efficiently by having the necessary resources, systems and controls to manage the associated risks.

1.3.2 The HKMA would expect an AI which has not previously acted as a receiving bank in an IPO, or which is proposing to act as a receiving bank in an IPO which is much larger than those it normally handles, to discuss the proposal with the HKMA well in advance. In considering the proposal, the HKMA would, in particular, wish to be satisfied that the AI has adequate systems and manpower resources for processing the share applications and is capable of recycling the application monies arising from the IPO in an efficient manner.

1.3.3 If an AI intends to act as a receiving bank in a large-scale IPO, the HKMA would expect the AI to have acquired sufficient experience and maintained a good track record in acting as a receiving bank, and be able to adequately plan for and manage the recycling process involving substantial amounts of application monies.

1.3.4 In determining whether an IPO is of a large size for the purposes of paras. 1.3.2 and 1.3.3, an AI should benchmark the scale of the IPO against its own financial strength (e.g. capital base). Other factors to be considered include the estimated amount of application monies to be recycled, the overall sentiment in the stock market at the time of the IPO and the expected level of demand from retail investors.

1.3.5 The HKMA would also expect AIs involved in an IPO (as a lending AI or a receiving bank) or in providing share margin financing to their clients to exercise adequate management oversight of such activities and observe the minimum business and control standards set out in this module.

1.3.6 Moreover, AIs, regardless of whether they are involved in an IPO, should institute the measures set out in section 6

to ensure proper handling of IPO refund cheques deposited or encashed by their clients.

1.3.7 The HKMA will monitor AIs' compliance with the minimum standards set out in this module through on-site examinations and off-site reviews (including regular analysis of relevant information submitted by AIs in their statistical returns).

2. Risk analysis of an IPO

2.1 General

2.1.1 An IPO involves a number of parties, including sponsors, underwriters, receiving banks and professional advisors (e.g. lawyers, accountants and property valuers). AIs may participate in an IPO as a sponsor, an underwriter or a receiving bank, the respective role and functions of which are described below:

- Sponsor – a sponsor is mainly responsible for preparing, coordinating and controlling the whole process of an IPO and dealing with relevant authorities (e.g. the SFC and the HKEx) on all matters arising from the IPO. In discharging these functions, the sponsor should be able to give impartial advice to its clients and comply with all applicable regulations, codes and practices (e.g. the listing rules and guidelines issued by the HKEx, and the Guidelines on Sponsors and Compliance Advisers (effective from 1 January 2007) and the Corporate Finance Adviser Code of Conduct issued by the SFC);
- Underwriter – an underwriter (or a syndicate of underwriters) of an IPO is a person (or a group of persons) who agrees to take up any new shares left unsold after the IPO;
- Receiving bank – although the functions of a receiving bank may vary from case to case, they generally cover the following:
    - the distribution of application forms and prospectuses;

- the collection of completed forms and application monies (e.g. cheques or cashier's orders) from the applicants subscribing for new shares;
- the processing of completed forms and application monies[5];
- the recycling of application monies in the interbank money market; and
- the arranging of refund of the application monies to unsuccessful or partially successful applicants.

2.1.2 As well as the above roles, an AI may act as a lending AI by providing short-term loans or stagging[6] finance to its clients to facilitate their subscription for new shares in an IPO.

2.1.3 This section focuses on analysing the major risks associated with AIs' involvement in an IPO as a lending AI or as a receiving bank.

2.2 Major risks to lending AIs

2.2.1 Credit risk is incurred by lending AIs when they finance their clients to subscribe for new shares in an IPO. Lending AIs may also be exposed to credit concentration risk if appropriate limits are not imposed to control the level of exposure to individual clients, or in respect of each new share issue. If the new share issue is heavily over-subscribed, the credit risk involved can be substantially reduced. This is because the actual lending to those borrowers subscribing for new shares would be reduced to the credit needed to finance the allotted shares, the number of which may be a small fraction of

[5] The processing procedures include: (i) numbering the application forms and the accompanying cheques or cashier's orders; (ii) rejecting applications which fail to comply with the relevant terms and conditions; (iii) delivering the application forms to a designated share registrar; (iv) providing reports to the sponsors and underwriters; (v) arranging the presentation of cheques and cashier's orders for clearing; and (vi) transferring the cleared funds to a designated account.

[6] Stagging refers to the practice of buying IPO shares at the offering price and then selling them once trading has begun.

the total number of shares applied for. However, it is difficult for a lending AI to predict accurately the subscription rate of an IPO. If the actual subscription rate is far lower than its estimate, the application monies would not be available to reduce the borrowers' outstanding loans to the lending AI.

2.2.2 Lending AIs incur a higher level of credit risk to the receiving bank, given that their exposure to the receiving bank, in terms of the total amount of refunds (being the sum of refund monies of all unsuccessful and partially unsuccessful applications of their borrowers) to be collected from the receiving bank to settle the outstanding loans of their borrowers (see also para. 2.3.7), is usually much larger than their exposure to individual borrowers.

2.2.3 With the allotted shares as the underlying collateral, lending AIs are exposed to the risk that the market value of the new shares may fall below the subscription price. This risk will increase if the subscription rate of the new share issue turns out to be lower than expected and, in particular, if the new share issue is under-subscribed. In principle, this market risk can be covered by a margin requirement.

2.2.4 Lending AIs may be exposed to the legal risk of not being able to hold onto the refund monies on the unsuccessful and partially unsuccessful applications for discharging the borrowers' outstanding loans and to protect their interest in the refund monies from the winding-up or bankruptcy of the borrowers. In this regard, the use of "specific purpose" trust arrangements[7] could provide a legal safeguard for lending AIs.

[7] The use of "specific purpose" trust arrangements is based on a well-established legal principle that a lender continues to have an equitable interest in the proceeds of a loan made for a specified purpose until the loan is utilised for the intended purpose. In terms of IPO subscriptions, this means that the portion of a loan which is not utilised for the purchase of new shares will not form part of the borrower's assets available for distribution on his bankruptcy. In other words, if the application is unsuccessful or partially unsuccessful, the refund monies will be held in trust for the lending AI, which could use the amounts to discharge the borrower's outstanding loan. The trust arrangement effectively deems the lending AI to be the ultimate beneficial owner of the refund monies.

2.3 Major risks to receiving banks

2.3.1 Although the sponsor bears the ultimate responsibility for the overall management of an IPO, the public image or reputation of a receiving bank may be seriously damaged if the IPO is not managed well. Moreover, a poorly managed IPO may lead to disruption of the receiving bank's normal business and operations.

2.3.2 The receiving bank may be exposed to operational risk by being liable to fines, claims or damages if there is any breach of the terms and conditions of the Receiving Bank Agreement or any operational error or mistake which gives rise to losses to other parties.

2.3.3 Where there is more than one receiving bank in an IPO, the sub-receiving bank(s) have to transfer all application monies to the main receiving bank on the refund day. The main receiving bank may be subject to credit risk and settlement risk if the sub-receiving bank(s) choose to effect the transfer on a cheque-vs-cheque basis other than using RTGS.

2.3.4 Owing to its role in recycling application monies, the receiving bank incurs credit risk to other counterparties (mainly AIs) to which it has recycled the application monies. The level of such exposures may be significantly higher than the receiving bank's normal credit limits on those counterparties as the receiving bank will likely increase the limits during the share subscription period to facilitate its recycling of application monies.

2.3.5 Without adequate planning for the recycling process (including a reasonable estimation of the amount of application monies to be recycled or the amount of temporary increase in interbank credit limits to be sought from other AIs), the receiving bank may face substantial pressure in recycling the application monies to other AIs within prescribed credit limits (including prudential limits agreed with the HKMA in advance for such purpose).

2.3.6 The lack of adequate planning for the recycling process could also have an adverse impact on the CAR of the receiving bank. Depending on the size of the receiving bank's capital base, a significant increase in credit

exposures to other AIs during the share subscription period may result in a substantial decline in its CAR. If the decline leads to a breach of the receiving bank's minimum CAR, regulatory consequences would ensue.

2.3.7 The receiving bank may also face liquidity risk arising from the default of major counterparties (which may include lending AIs) to which it had lent the application monies, especially in the case of a large and heavily over-subscribed new share issue. Given the substantial amounts involved it is possible that the receiving bank will not have adequate cash resources of its own to refund the application monies. In particular, the receiving bank may find it difficult to collect the amounts due from other lending AIs it had funded, as such AIs would try to set off their borrowings from the receiving bank against the amounts that are due from the receiving bank as refund monies.

2.3.8 Despite the fact that the receiving bank holds the application monies in trust for the applicants, it could take time for the courts to resolve the respective rights and obligations of the various parties in the case of a dispute. Moreover, the assets in which the application monies are held form an indistinguishable part of the assets of the receiving bank, thus making it difficult for the receiving bank to use such assets to meet its financial obligations before the dispute is settled.

2.3.9 There is also a strategic risk for AIs which plan to act as receiving banks, as doing so may require a long-term and continuous investment in AIs' operational and manpower resources in order to keep pace with the market developments (e.g. the introduction of eIPO). If the IPO activities in the stock market are far below original expectations, AIs may not have a sufficient return from this business to cover their investment cost.

3. Risk analysis of share margin financing

3.1 General

3.1.1 Share margin financing is a type of formula lending commonly extended by AIs to their clients to facilitate their investments in listed stocks. Such lending is

analogous to securities margin financing which is regulated by the SFC under the SFO. However, AIs do not fall within the SFC's regulatory regime for securities margin financing. The HKMA remains responsible for supervising share margin financing activities undertaken by AIs.

3.1.2 Lending AIs, in their provision of share margin financing, will generally prescribe different margin requirements for different types of shares (e.g. blue-chips, second or third liners). While most lending AIs will only accept shares listed on the HKEx as collateral for such lending, certain AIs specialising in this type of lending may accept shares listed on overseas stock exchanges as well.

3.1.3 In order to protect the interest of a lending AI, shares pledged as collateral will normally be transferred into the name of the AI's nominee company, irrespective of whether the shares are held in physical form (i.e. with a share certificate) or with CCASS[8].

3.1.4 Some lending AIs are also engaged in the business of providing share margin financing to stockbrokers for their operational needs (particularly in respect of financing their business of securities margin financing).

3.1.5 This section analyses the major types of risk faced by lending AIs in their provision of share margin financing to investors and stockbrokers.

3.2 Major risks to lending AIs

Credit risk

3.2.1 Like other types of lending, credit risk is incurred by lending AIs engaged in the business of share margin financing. The level of credit risk assumed varies, depending on the lending AI's underwriting standards,

[8] CCASS was introduced in June 1992 and is operated by the Hong Kong Securities Clearing Company Limited. Individual investors who opt to keep their holdings in CCASS can do so through a member of the system. This arrangement reduces scrip circulation by effecting the transfer of title through the transfer of stock balance from the vendor's account to the buyer's account with CCASS, thus obviating the need for any physical transfer of share scrip.

particularly with respect to the margin requirements established for different types of stocks.

3.2.2 The level of credit risk in share margin financing could be relatively low if a lending AI has established prudent underwriting standards and lending limits, and adhered to and properly monitored such standards and limits. Deviations from such standards and limits would increase credit risk to the extent of the degree, significance and frequency of deviations.

3.2.3 Single borrower limits and the maximum amount of a listed company's shares which a lending AI may take as collateral will also affect the level of credit risk in share margin financing.

3.2.4 Lending AIs which provide share margin financing to stockbrokers (or their related finance companies) may be subject to additional credit risk if those stockbrokers have borrowed excessively from lending AIs (e.g. to finance their speculative activities) by improper pledging of their clients' shares with the lending AIs (see also para. 3.2.10), thereby increasing its default risk[9]. To address these risks, the SFC has recently finalised a set of amendments to its existing rules and the SFC Code, which came into effect on 1 October 2006[10]. Lending AIs should assess the implications of such changes on their exposures to stockbrokers (or their related finance companies).

Market risk

3.2.5 Although the value of share collateral is continuously affected by changes in the share prices of such collateral,

---

[9] The collapse of C.A. Pacific Securities Limited and C.A. Pacific Finance Limited in January 1998 revealed the risk to clients and lending AIs arising from the improper pledging to lending AIs of clients' shares by stockbrokers or their related finance companies (e.g. unauthorized pledging of the shares of cash clients). Since the C.A. Pacific incident, the SFC has implemented measures to bring the provision of securities margin financing within its regulatory framework.

[10] The amendments include: (i) the introduction of a re-pledging limit under the Securities and Futures (Client Securities) Rules, which will be implemented in two phases; (ii) the adjustment of haircut percentage rates under the Securities and Futures (Financial Resources) Rules; and (iii) increased disclosure to clients about pooling risks and re-pledging practices. These measures are aimed at, among other things, promoting more cautious lending and borrowing practices among the providers of securities margin financing regulated by the SFC.

there is no direct market risk to the lending AI. Market risk only becomes a factor if the borrower defaults and the lending AI has to rely on disposal of the share collateral to collect its loan.

3.2.6 If the share collateral to be disposed of is concentrated in the shares of a single company or a group of related companies, the lending AI could experience a sharp decline in the share prices if it tries to sell the shares in the market within a short period of time. In these circumstances, the level of market risk will be high even if the lending AI carries out effective marking-to-market procedures on the share collateral held.

Operational risk

3.2.7 Operational risk in share margin financing refers, in particular, to the risk of potential loss arising from inadequate systems, procedures and controls for:

- monitoring the collateral positions of each of the outstanding share margin loans; and
- controlling the safe custody, deposit and withdrawal of pledged shares (see section 7 of CR-G-7 "Collateral and Guarantees" for more guidance).

3.2.8 The level of operational risk incurred by a lending AI would depend, among other things, on how effective its systems, procedures and controls are in responding quickly to shortfalls in collateral value during the course of a business day and in preventing or minimising operational oversight or lapses in the management of share collateral.

Legal risk

3.2.9 As share margin financing is a mature product in Hong Kong with fairly standard documentation, the legal risk involved should generally be low. However, there could be special situations in which the legal risk assumed by individual lending AIs is increased.

3.2.10 Legal risk may arise if a lending AI has accepted share collateral from stockbrokers (or their related finance companies) which have improperly pledged the shares of their clients with the lending AI. For example, the

stockbroker may not have obtained the necessary authorization from its clients to pledge their shares.

3.2.11 Legal risk could also increase if a lending AI has to sell a client's shares at a depressed price to meet a margin call and immediately afterwards the share price increases significantly. The client may institute legal action against the AI for improper selling of his shares. Such risk can be reduced if the AI's standard documentation covers this eventuality. For example, the client agreement should clearly specify the circumstances in which a client's positions may be closed without the client's consent.

3.2.12 A lending AI should be particularly mindful of the legal risk that may arise from any selective selling of a client's pledged shares at forced sale prices to meet the margin requirement. To better manage such risk, the lending AI should have adequate policies and procedures in place to govern its forced sale actions, and ensure that such policies and procedures are adhered to. Where necessary, legal advice should be sought on the suitability of such policies and procedures.

Reputation and compliance risks

3.2.13 As share margin financing involves contacts with clients when a lending AI conducts the procedures on margin call, forced liquidation of shares and collection of remaining debt from clients, complaints from clients about the AI's handling of each of these cases could easily emerge. Any adverse publicity about the AI's handling of such cases may affect its reputation and market perception.

3.2.14 Other sources of adverse publicity may stem from misconduct or malpractice on the part of a lending AI's staff, including soliciting clients to borrow for the purpose of speculating in the stock market or engaging in rat-trading, insider dealing, front running or late allocation of deals. Such misconduct or malpractice, if substantiated, will have regulatory consequences.

3.2.15 To reduce reputation and compliance risks, lending AIs should maintain adequate policies and procedures for handling client complaints and ensuring compliance with relevant regulatory standards and requirements,

including the Code of Banking Practice and, where applicable, the SFC Code.

4. Financing subscription for new share issues

4.1 Policies and procedures

4.1.1 Lending AIs should maintain well-documented policies and procedures for the financing of new share issues, which should adequately address the risks described in subsection 2.2.

4.1.2 The policies and procedures must be approved by the Board (or a committee with delegated authority) or senior management, as appropriate, and be regularly reviewed and updated to keep abreast of changing market developments.

4.2 Prior analysis and approval

4.2.1 Prior to financing the subscription for a new share issue, lending AIs should conduct a thorough analysis covering, among other things, the following:

- the potential impact on the CAR of the lending AI;
- the likely market response to the issue (e.g. the estimated subscription rate);
- the overall sentiment in the stock market; and
- the competence, reliability and reputation of the sponsor(s), lead manager(s), underwriter(s) and receiving bank(s) of the issue.

Lending AIs should also have regard to other risk factors affecting the issuer (e.g. its financial strength or business outlook) based on available information in their analysis.

4.2.2 The financing programme for each new share issue should have the prior approval of senior management or a committee with delegated authority (e.g. Asset and Liability Management Committee or Credit Committee).

4.3 Credit limits

Total exposure in a new share issue

4.3.1 There should be an overall limit to control a lending AI's total exposure to investors and stockbrokers in a new share issue. This limit should be properly determined and approved, having regard to the results of analysis referred to in para. 4.2.1. In setting this limit, lending AIs should not be swayed by fads or by what is fashionable (e.g. new concept business).

4.3.2 As the exposure of a lending AI to the receiving bank in a new share issue is effectively short-term and unsecured, the overall limit for the new share issue should also be set in relation to the lending AI's normal credit limit on the receiving bank. Specifically, the lending AI should not take on a much larger exposure during the IPO than it would be prepared to accept for short-term unsecured lending to the receiving bank in the normal course of business.

4.3.3 A lending AI should therefore carefully consider and justify any plan to increase its exposure to the receiving bank of an IPO (e.g. by raising its existing credit limit on the receiving bank), albeit only for a short period of time during the IPO. In particular, the lending AI should ensure that:

- the increase in exposure to the receiving bank is supported by the financial strength of the receiving bank, the expected outcome of the new share issue, and prevailing market conditions; and
- the AI has the capacity to withstand the credit and liquidity risks arising from the increase in exposure to the receiving bank (taking into account any available contingency funding arrangements).

Exposure to individual clients

4.3.4 Lending AIs should specify in their credit policies a limit on the maximum exposure that they are prepared to incur on lending to individual clients, taking into account the risk of concentrated lending.

4.3.5 For a locally incorporated AI, such exposure cannot in any case be more than 25% of its capital base (i.e. the statutory limit specified in §81(1) of the Banking Ordinance), except to the extent that the exposure is

secured by collateral (such as cash deposits) accepted by the MA under §81(6) of the Banking Ordinance. An overseas incorporated AI should observe a similar prudential limit.

4.3.6 It should however be noted that the 25% statutory limit sets the upper cap for each individual exposure. Lending AIs should consider whether a lower limit is more appropriate with regard to the creditworthiness of each client.

4.4 Specific lending arrangements

4.4.1 The use of specific purpose trusts (see also para. 2.2.3) and nominee companies (see para. 4.4.3) is important in helping lending AIs reduce the risks arising from the financing of new share subscriptions.

4.4.2 Lending AIs should structure their lending arrangements so that they are legally protected, as far as possible, from the winding-up or bankruptcy of the issuer, the receiving bank, or their clients in an IPO. Among other things, the loan documentation (e.g. client lending agreements) should make it clear that the application monies are lent on purpose trusts, and refund monies are therefore held on trust for the lending AI. Lending AIs should take their own legal advice on this matter.

4.4.3 In addition, a lending AI should ensure that all applications are submitted via, and refund monies received by, a nominee company owned by the AI ("lender nominee company"). In other words, the borrower should be required to apply for the new shares in the name of the lender nominee company. This arrangement enables the lending AI to keep track of and control the movement of the application and refund monies.

4.5 Margin requirement

4.5.1 Lending AIs should apply a reasonable margin requirement[11] on their lending to individual clients. This

[11] Generally speaking, the market norm is for a 10% margin to be imposed on such lending.

requirement may be satisfied by the deposit of collateral (in the form of cash or securities) with the lending AIs or by setting an appropriate loan-to-value ratio.

4.5.2 The margin requirement should also apply to lending to stockbrokers connected with a lending AI. The lending AI is required to ensure that a reasonable margin is applied by its connected stockbrokers to lending to their clients as well.

4.6 Prior funding arrangements

4.6.1 Lending AIs should follow their normal credit standards, and limit their total exposure in each new share issue to an amount which is well within their ability to obtain funding to meet their obligations on the settlement date. Where appropriate, they should enter into prior funding arrangements (e.g. with the receiving bank) before lending substantial amounts to their clients.

5. Acting as receiving bank in new share issues

5.1 Business strategy

5.1.1 AIs which plan to engage in the business of acting as a receiving bank in IPOs should carefully consider whether this activity fits their business strategy and objectives. They should conduct a comprehensive cost-benefit analysis to evaluate whether such business is commercially justified, taking into account the projected returns and the costs of the initial and continuous investment in both operational and manpower resources.

5.1.2 An AI should only take on the role of a receiving bank in an IPO which is manageable in relation to the AI's operational and financial capacity. It is also important for the AI to conduct a thorough analysis in advance of the potential financial impact, particularly on its CAR, arising from the IPO if it were to act as the receiving bank in the IPO.

5.1.3 In the circumstances specified in para. 1.3.2, the AI should discuss with the HKMA well in advance of its plan to be the receiving bank of an IPO.

5.2 Role and responsibilities

5.2.1 Receiving banks should have a clear understanding of the respective role and responsibilities of the receiving bank and the sponsor in an IPO. These matters should be clearly specified in the Receiving Bank Agreement. Receiving banks should also refer to Chapter 3A of the Listing Rules issued by the HKEx and the Corporate Finance Adviser Code of Conduct issued by the SFC, which detail the responsibilities of an advisor acting as a sponsor of IPOs.

5.2.2 As a general principle, the sponsor bears ultimate responsibility for the overall management of an IPO, and the receiving bank's role is to act as an agent of the sponsor and to follow the sponsor's instructions. If, however, the receiving bank is not comfortable with the sponsor's instructions it should endeavour to make this known to the sponsor and make recommendations where appropriate.

5.2.3 Receiving banks which use the Internet to collect applications from their clients or the general public for subscription for new shares in an IPO (i.e. an eIPO) should comply with "Guidelines for Electronic Public Offerings" issued by the SFC and "Operational Procedures for eIPO Applications Submitted via Banks/Stockbrokers" issued by the Federation of Share Registrars Limited.

5.2.4 Receiving banks should ensure that the IPO process runs smoothly by maintaining close cooperation, good communication and a climate of trust with the sponsor.

5.3 Initial assessment

5.3.1 A receiving bank should ensure that it is given as much information on the new share issue as possible to the extent that confidentiality restrictions do not preclude this. This will help the receiving bank in forming its own view of the likely response to the new share issue and the adequacy of manpower and operational resources it has made available to handle the new share issue.

5.3.2 There should be as accurate an assessment as possible of the likely popularity of the new share issue. This should be kept in view throughout the process and revised accordingly. While this is primarily a matter for

the sponsor, if the receiving bank is uncomfortable with the estimates made by the sponsor it should make this known clearly to the sponsor.

5.3.3 A receiving bank should satisfy itself that proper consideration is given to the number of branches to be designated as receiving branches. Assurance that the arrangements will be sufficient to cope with the demand should be the first priority. This may mean designating more branches as receiving branches than has been the practice hitherto.

5.4 Management of application process

5.4.1 A receiving bank should ensure that sufficient resources, including management resources, are devoted to the process. For popular issues, the receiving bank should establish a command centre to coordinate the receipt of information about the subscription and to escalate issues to senior management should that prove necessary.

5.4.2 A receiving bank should arrange suitably trained staff to answer enquiries from its own clients and the general public in relation to matters arising from an IPO. Enquiries relating to dealing in securities or investment advice should be referred to and answered by “relevant individuals” (within the meaning of §20 of the Banking Ordinance) of the receiving bank.

5.4.3 Staff members responsible for handling an IPO should be fully conversant with the IPO process as well as the relevant bank policies, so that they can provide accurate and clear information in handling IPO-related enquiries[12]. It would be worthwhile to consider designating one or more than one staff member at each receiving branch to be responsible for answering public enquiries during the IPO process.

5.4.4 A receiving bank should ensure that its “relevant individuals” strictly observe the restrictions on unsolicited

[12] Such information includes the closing times for different purposes such as the receiving bank’s internal closing time for its own securities clients to submit applications through the bank and the official closing time for the general public to submit application forms at the receiving branches.

calls when interacting with potential investors in an IPO. Specifically, such staff members should not approach any person who is not one of the bank's existing securities clients and request him to subscribe for new shares through the bank.

5.4.5 A receiving bank should not distribute to the general public (i.e. non-securities clients of the bank) new share white application forms that are pre-stamped with the company chop of any stockbroker.

5.4.6 A receiving bank, in collaboration with the sponsor, should ensure that security arrangements, such as in respect of queue management, are appropriate, and that necessary measures are taken to minimise risks to safety and public order.

5.4.7 In addition, the receiving bank should cooperate with the sponsor to ensure that a sufficient number of unstamped white application forms are available for collection by the general public at the receiving branches. Attention should be given to the requirement under the Companies Ordinance that application forms should be distributed with prospectuses[13]. Guidance should also be provided to the receiving branches on how to handle any demand for a large volume of these forms and prospectuses.

5.4.8 If an AI is to take up the role of a receiving bank for other IPO(s) concurrently, the following measures should be adopted:

- the AI should consider the need to deploy different receiving branches for each IPO. In case a particular branch is to distribute and collect forms for two or more IPOs at the same time, there should be sufficient distance between and clear directions for the queuing and collection areas,

[13] Based on section 38(3) (in respect of locally incorporated companies) or section 342(3) (in respect of overseas incorporated companies) of the Companies Ordinance, a receiving branch should cease distributing application forms if prospectuses run out of stock. If the English and Chinese versions of the prospectus are separately issued, and if either version runs out of stock or ceases to be available at a receiving branch, the distribution of application forms and prospectuses at the relevant branch should cease and not resume until such time when both versions of the prospectus are again made available for distribution to the general public at that location.

and with adequate manpower deployed to manage the operation;

- the AI should provide adequate guidance to investors in respect of queuing and putting the IPO forms in the appropriate drop-in box(es); and
- given the expected pressure on operational capacity, the AI should be particularly alert to and avoid any possible errors and omissions in the process of handling application forms and consolidating individual yellow form applications into omnibus applications through CCASS.

5.5 Contingency plan

5.5.1 A receiving bank should agree in advance with the sponsor a formal contingency plan for coping with an unexpected level of interest in a new share issue. This should include the following considerations:

- the possibility of adding branches as receiving branches if necessary, including the related publicity issues;
- the possibility of bringing in another receiving bank to assist in the collection or processing of applications;
- the possibility of extending the operating hours for submission of applications, if feasible;
- arrangements for printing and distributing additional copies of application forms and prospectuses if necessary;
- arrangements for assigning additional staff if necessary; and
- arrangements for liaison with the police on crowd management issues.

5.5.2 A receiving bank should work closely together with the sponsor, should there be any question as to whether contingency measures should be triggered. While this is primarily a matter for the sponsor, the receiving bank should ensure that any concerns it may have are addressed.

5.5.3 A receiving bank should promptly notify the HKMA of any major problems arising from the IPO.

5.6 Specific trust arrangements

5.6.1 Receiving banks should ensure that they have adequate arrangements to protect application monies until the allotment of shares to successful applicants and the despatch of refund monies to unsuccessful and partially successful applicants are completed.

5.6.2 A receiving bank is usually required under the Receiving Bank Agreement to hold the application monies in a New Issue Account on trust for the applicants through its nominee company. This means that the monies in the New Issue Account belong beneficially to the applicants and the issuer is entitled to receive only the amount which represents payment for the allotted shares. The remaining balance of the application monies after allotment of shares is then transferred by the receiving bank to a Refund Account which ensures that the monies continue to be held in trust until they are refunded to the applicants.

5.7 Recycling of application monies

5.7.1 A receiving bank should use its best efforts to recycle the application monies in the money market. The aggregate exposure of the receiving bank to individual AIs for recycled application monies and other types of financial exposure should not exceed the normal credit limit for each AI, subject to para. 5.7.2.

5.7.2 In cases where a receiving bank's normal credit limit on an AI is relatively low, the receiving bank may raise such limit for a short period of time to facilitate the recycling of application monies provided that any such increase is carefully justified and controlled, and supported by senior management approval.

5.7.3 Although exposures to AIs are exempt under §81(6)(a) of the Banking Ordinance, a receiving bank should not normally increase its credit limit on an AI in excess of 25% of its capital base or, if it is an overseas incorporated AI, of the capital base of the bank as a whole.

5.7.4 Where there is more than one receiving bank in an IPO, sub-receiving banks should ensure that they will have sufficient funds for effecting the transfer of application monies to the main receiving bank at the scheduled time on the refund day.

6. Handling of IPO refund monies

6.1 Security measures for IPO refund cheques

6.1.1 In the light of some fraud cases[14] involving stolen IPO refund cheques in the past, AIs should exercise due care in handling IPO refund cheques for their clients.

6.1.2 To prevent misappropriation of IPO refund cheques, the banking and securities sectors have implemented the following security measures for paper-based applications:

- Partial disclosure of ID / passport number – part of the Hong Kong identity card (ID) number or passport number, as the case may be, of an IPO subscriber will be printed below the subscriber's name (i.e. the payee) on the refund cheque. The remaining digits of the number are deliberately masked and replaced by asterisks for privacy reasons; and
- Verification of ID / passport number – the IPO subscription forms will draw the subscribers' attention to the fact that their bankers may require verification of their Hong Kong ID number or passport number before encashment of their refund cheques.

6.1.3 AIs should have procedures in place to handle instructions from clients to deposit or encash their IPO refund cheques. Specifically, an AI should cross-check both the name and the printed part of the Hong Kong ID /

[14] In these cases, after stealing the refund cheques from the mail boxes of the IPO subscribers, the culprits opened new deposit accounts in the name of the cheque payees, generally by presenting genuine identity documents after a formal change of name (i.e. "Acknowledgement of Application for a Hong Kong Permanent Identity Card" which is a temporary identity document issued by the Immigration Department). The stolen cheques were later deposited into the new accounts, and funds were subsequently withdrawn from the accounts in the form of cash.

passport number of the payee shown on the refund cheque against their records (i.e. the corresponding information of the holder of the account in which the cheque is to be deposited). If the disclosed portion of the ID / passport number shown on the refund cheque cannot be matched against the AI's records (e.g. where a different identity document of the payee is maintained in the AI's records), the AI should request the client to produce the relevant identity document for verification.

6.1.4 AIs should ensure that their policies and procedures for verification of the identity of the payee of the IPO refund cheques provide clear guidance to staff as to the circumstances in which such cheques should be accepted or rejected.

6.1.5 For the effective implementation of the above security measures, AIs should:

- ensure their front-line staff[15] who may be involved in handling IPO refund cheques are adequately educated of the required checking procedures; and
- be alert to any irregularity identified when they conduct the required customer due diligence on clients of newly opened accounts[16]. This will help in ascertaining whether accounts opened are for genuine purposes.

6.2 Electronic refund for eIPO applications

6.2.1 Another preventive measure to minimise the risk of misappropriation of refund monies is to automate the payment process through electronic refund[17]. At present, electronic refund is only available to clients who submit their applications through eIPO. The users of eIPO are mostly stockbrokers, custodian banks, professional

[15] These should include all staff members who are responsible for handling cheque deposits, regardless of the means of depositing the cheques, e.g. through counters, drop-in boxes or ATM machines.

[16] See also the "customer due diligence" requirements specified in the Guideline on Prevention of Money Laundering and its Supplement issued by the HKMA.

[17] Electronic refund will also have the benefit of eliminating delay in the refund process or the chance of losing refund cheques during the mailing.

investors as well as retail clients with bank accounts (including securities and settlement accounts) with an e-banking facility.

6.2.2 The electronic refund process has not been extended to paper-based applications in the light of operational issues raised by the industry[18]. The principal concern is that, unless the applications are submitted through eIPO using the proprietary electronic platform operated by individual banks, it will not be possible for the banks to build in any safeguard or cross-checking device to ensure that refund monies are not credited to the wrong account (e.g. due to incorrect account number provided by the subscriber or input mistake made by bank staff).

7. Share margin financing

7.1 Policies and procedures

7.1.1 Lending AIs should maintain well-documented policies and procedures for share margin financing, which should be adequate to guard against the risks described in subsection 3.2.

7.1.2 The policies and procedures should be approved by the Board (or a committee with delegated authority) or senior management, as appropriate, and be regularly reviewed and updated to ensure that they remain appropriate and are compatible with changing market circumstances.

7.1.3 In particular, lending AIs should regularly review their policies and procedures in the light of changes in the relevant legislation and codes, such as the SFO, the Banking Ordinance, the Code of Banking Practice and the SFC Code (see also para. 3.2.4) and assess the implications of such changes on the AIs' exposures. If necessary, legal advice should be sought.

[18] The security measures set out in subsection 6.1 have already significantly mitigated the risk of misappropriation of refund cheques for paper-based applications. Nevertheless, it is expected that the increasing use of eIPO by retail investors or the introduction of new IPO application methods (e.g. HKEx's electronic white form) over time will further increase the share of refund monies to be processed electronically.

7.1.4 The policies for share margin financing should, among other things, include the following:

- Overall exposure limit on share margin financing (e.g. as a percentage of total loans);
- Credit assessment criteria – lending AIs should set out the criteria and information used for assessing borrowers' repayment capacity and setting credit limits;
- List of stocks that may be accepted as share collateral – lending AIs should draw up a list of acceptable stocks in different categories (e.g. blue chips, second liners, and third liners, etc.), which should be subject to regular review and updating;
- Maximum loan-to-value ratio for each category of stocks – lending AIs may adopt different ratios depending on their level of expertise and proficiency in share margin financing. However, they should exercise prudence in setting the ratios and have regard to the underlying financial strength, liquidity and price volatility of individual stocks. If the maximum loan-to-value ratios adopted by a lending AI exceed the prevailing market norms [19], the AI should discuss the situation with the HKMA;
- Minimum margin requirement - if the market value of the share collateral, or the portfolio of share collatered, pledged by the borrower falls below this level, the borrower should be asked to top up the margin immediately;
- Limits to control concentration risk, including:
  - the maximum loan amount to a single borrower or a group of connected borrowers

[19] As a reference, the current market norms are: (i) around 50-60% for blue chips (with higher ratios of, say, 70% adopted by lending AIs which are specialised in share margin financing and have the expertise and sophisticated risk management systems to control the risks involved); and (ii) around 30-40% or below for selected second and third liners. Lending AIs should note that such market norms may change from time to time according to market situations.

(in any case the limit should not exceed 25% of a lending AI's capital base);

- the maximum proportion of shares in a single company that can be accepted as collateral (e.g. no more than 5% of the issued shares of any company); and
- the maximum proportion of shares in a single company or a category of stocks which can be included as share collateral;

- Compliance with §§80(1) and 80(2) of the Banking Ordinance – lending AIs should ensure that these statutory requirements which respectively prohibit an AI from lending against the security of its own shares and against the security of the shares of any holding company, subsidiary or fellow subsidiary of the AI are met;
- Credit authorities (and their limits) for approving share margin financing (including those for approving deviations from policies);
- Method and frequency of collateral revaluation, e.g. the portfolio of share collateral is to be marked to market at least daily, and more often during the day if the stock market is highly volatile (see para. 7.5.1);
- Conditions triggering margin call and forced liquidation of accounts, and the approach adopted for margin call monitoring and forced liquidation;
- Relevant management information (e.g. MIS reports) to be produced, including the flow of information, the nature of each MIS report, the responsible persons who review these reports and the frequency of review;
- Measures to enhance investor protection which are relevant to the share margin financing activities of AIs (e.g. the handling of clients' assets) contained in the SFO. In addition, in order to enhance the quality and timeliness of disclosure of account information, lending AIs are required to comply with the requirements of the

Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules applicable to margin clients within three months of the date of issuing this module;

- Procedures for handling customer complaints (see IC-4 "Complaint Handling Procedures" for further guidance).

7.2 Lending principles

7.2.1 Lending AIs should ensure that credit facilities granted for share margin financing are subject to prudent credit-granting criteria applicable to other types of credit. See CR-G-1 "General Principles of Credit Risk Management" and CR-G-2 "Credit Approval, Review and Records" for further guidance.

7.2.2 In the case of lending to stockbrokers (or their related finance companies), it is important for lending AIs to maintain an adequate understanding of their financial conditions (including their leverage position and funding structure) as well as business and management practices, and be alert to any signs of deterioration in their creditworthiness or market standing. In assessing the financial conditions of stockbrokers (or their related finance companies), lending AIs should consider soliciting from these entities for review copies of financial returns that they have submitted to the SFC under section 56 of the Securities and Futures (Financial Resources) Rules.

7.2.3 Share margin facilities should be granted with an acceptable margin value of pledged shares. Lending AIs should determine the acceptable margin value for different categories of stocks. The list of acceptable stocks in different categories, and their respective margin requirements, should be regularly reviewed, updated and approved by the relevant officer (e.g. Chief Credit Officer) or committee with delegated authority (e.g. Credit Committee), taking into account the liquidity and volatility of those stocks under prevailing market conditions.

7.2.4 In assessing the suitability of the list of acceptable stocks, lending AIs should also pay special attention to stocks in particular industries or stocks with a common nature

(such as Internet or technology-related stocks, property-related stocks, and energy or mineral-related stocks) and determine whether their respective loan-to-value ratios remain appropriate, having regard to the volatility in the price and trading of such stocks, the financial strength and prospects of individual companies as well as the stage of the business cycle such industries or companies are in.

7.2.5 Lending AIs should ensure that any share margin facilities granted to connected parties are at arm's length. The terms and conditions of such facilities (e.g. in terms of interest rates charged, collateral and repayment terms) should be based on normal business terms and in compliance with established policies and procedures (see CR-G-9 "Connected Lending" for more guidance).

7.3 Credit monitoring and reporting systems

7.3.1 Share margin account positions should be monitored (e.g. by account officers) and revalued (e.g. by the back office) on a daily basis. See CR-G-3 "Credit Administration, Measurement and Monitoring" for general guidance).

7.3.2 Lending AIs should have adequate procedures to govern margin call, top-up and liquidation requirements for their share margin financing business (see subsection 7.5).

7.3.3 Lending AIs should maintain an effective system for generating management reports which are detailed enough for senior management review and for identifying exceptions in a timely manner. Management reports for share margin financing should give adequate and timely information on the market value of shares pledged, utilisation of facilities and any need for margin calls. They should include:

- margin call and excess reports which highlight all share margin accounts with outstanding balances exceeding the respective authorized credit limits or loanable values based on the market value of share collateral held (see also para. 7.5.1);
- analysis of share collateral by type and margin ratios; and

- concentration of exposure to share collateral or clients.

Such reports should be generated and reviewed by designated officers on a daily basis.

7.3.4 Lending AIs should initiate follow-up actions (or margin calls) immediately when the outstanding account balance of a client exceeds its authorized credit limit or margin limit. Such actions should be properly documented.

7.3.5 Lending AIs should maintain adequate systems for dealing with a sudden fall in the stock market, and should carry out regular stress tests on their share margin portfolio to assess the resilience of the portfolio to a significant decline in stock prices (see IC-5 "Stress-testing" for further guidance). They should ensure that the share margin portfolio is not subject to excessive market risk.

7.3.6 There should be a system of regular internal audits or independent reviews of lending AIs' share margin financing business, with findings reported to senior management for instituting prompt remedial action.

7.3.7 The Board and senior management should be regularly apprised of the performance of the share margin financing portfolio and relevant risks and controls through periodic management reports and meetings.

7.4 Acceptance and management of share collateral

7.4.1 In accepting clients' shares from stockbrokers (or their related finance companies) as collateral, lending AIs should ascertain that the entities concerned are licensed under the SFO for carrying on business in dealing in securities or securities margin financing.

7.4.2 In addition, lending AIs should, on a best efforts basis, conduct the following precautionary measures to mitigate the risk of unauthorized pledging of clients' shares by the entities mentioned in para. 7.4.1:

- obtain written confirmation from the entities that they have obtained proper client authorization for the pledged shares;

- conduct sample checking of the proof of clients' authorization, to the extent practicable, upon the initial extension of credit facility to the entities and thereafter on an annual basis;
- review copies of the annual external auditors' reports requested from the entities that they have submitted to the SFC under section 4 of the Securities and Futures (Accounts and Audit) Rules[20] to understand their state of compliance with the Securities and Futures (Client Securities) Rules; and
- review any other information useful for analysing the entities' positions in securities margin financing (e.g. by obtaining from the entities for review copies of financial returns the entities have submitted to the SFC under section 56 of the Securities and Futures (Financial Resources) Rules).

Where necessary, lending AIs should solicit their own legal advice on how to minimise the risks of unauthorized pledging of shares associated with such lending.

7.4.3 Lending AIs should have adequate procedures to control the safe custody, deposit and withd rawal of pledged shares (see CR-G-7 "Collateral and Guarantees" for more guidance).

7.4.4 Lending AIs should ensure that loan and collateral documents are properly prepared and verified, and all pledged shares are held in the name of lending AIs' nominee companies to protect their legal interests.

7.4.5 Lending AIs should keep proper records of the location of share collateral and conduct independent stock counts regularly. Clients' accounts maintained with CCASS or

---

[20] Under the Securities and Futures (Accounts and Audit) Rules, licensed corporations and their associated entities are required to submit auditors' reports to the SFC. This auditors' report must contain a statement of the auditor's opinion as to whether, during the financial year in question, the firm (i) had systems of controls in place that were adequate to ensure compliance with sections 4(4), 5, 10(1) and 12 of the Securities and Futures (Client Securities) Rules, and (ii) has complied with these provisions.

other custodians should be reconciled against the AI's records by independent staff on a timely basis and any discrepancies should be dealt with promptly.

7.5 Monitoring of collateral value

7.5.1 As share margin financing is based on the value of shares pledged, there should be established procedures to monitor the market value of the share collateral for making margin calls to clients. As the stock market can be volatile, lending AIs' systems should be capable of revaluing the portfolio intraday at short notice or on a continuous basis whenever there is a need to do so. At a minimum, the portfolio value of each account should be revalued every day. Accounts with insufficient margin should be required to be topped up immediately.

7.5.2 Senior management of lending AIs which are actively involved in share margin financing should keep a close watch on the share margin portfolio and review the position every morning before the market opens. Clients who have failed to top-up margin should not be allowed to continue to use the facility, and consideration should be given to liquidating their positions if the situation warrants.

7.5.3 Pursuant to subsections 7.3 and 7.4, lending AIs should ensure that:

- the value of shares held as collateral for each share margin transaction at all times exceeds the loan amount by the margin required under the lending AI's share margin financing policies;
- the lending AI has good title to the collateral (i.e. pledged shares are held in the name of the AI's nominee company); and
- other safeguards (e.g. an effective mark-to-market system and controls to avoid concentration risk) are in place.