

NOTE FOR FINANCE COMMITTEE

Securities and Futures Commission Budget for the Financial Year 2001-02

PURPOSE

Encl. The budget of the Securities and Futures Commission (SFC) for 2001-02 is submitted at the Enclosure for Members' information. This note highlights the main features of the 2001-02 budget and compares the approved budget for 2000-01 with the latest estimates. Members may wish to note that, for the ninth consecutive year, the SFC has not requested the Government to make an appropriation to fund its operation.

BACKGROUND

2. On 12 April 1989, Members noted the following procedures for the approval of the SFC budget (FCR(89-90)12) –

- (a) the SFC will submit its budget to the Administration for the next financial year before 31 December;
- (b) the Administration will examine the SFC budget in January and present it to the Finance Committee for information in January/February;
- (c) the Administration will then submit the SFC budget to the Chief Executive for approval; and
- (d) the Administration will table the approved SFC budget in the Legislative Council and will, at the same time, submit the request for recurrent Government grant in the context of the draft Estimates.

In 1995, the authority for approval for SFC budgets was delegated to the Financial Secretary.

3. The SFC submitted in December 2000 its budget for 2001-02 to the Financial Secretary. The budget was subsequently revised in late February to incorporate the latest projection of the inflation rate and the levy income on securities transactions, which constitutes the major source of income for the SFC. Thus, we were unable to prepare the submission on the SFC budget in strict accordance with the time schedule set out in paragraph 2 above. Nonetheless, as the SFC requires no Government appropriation for the coming financial year, it will cause no operational problem to the SFC as long as the budget is approved before the beginning of the new financial year.

FUNDING OF THE SFC

4. Part VII of the Securities and Futures Commission Ordinance (Cap. 24) provides that the SFC may be financed by transaction levies, government appropriation and fees and charges on services rendered to market operators and participants. Since 1993-94, the SFC has not requested for government appropriation, and as a result, the funding of the SFC today has practically come entirely from the market in the form of levies and fees and charges.

5. SFC's levy income comes from the securities and futures markets. The current rate of levy on securities transactions ("securities levy") is 0.01% which is shared equally between the SFC and the Stock Exchange of Hong Kong (SEHK). For futures contracts trading, the current levy is \$1 (or \$0.2 for mini-futures contracts) per leviable transaction on both the buyer and seller.

6. As regards fees and charges, the SFC adopts, to the extent possible, the principle of full cost recovery when setting the level of its fees and charges. The rates of SFC fees and charges have not been revised since 1994. Despite two attempts to adjust the rates of fees and charges to maintain the full cost recovery principle against inflation, the amendment rules for the proposed fees and charges revision were revoked twice by the then Provisional Legislative Council on 15 October 1997 and 26 March 1998. Following the Government's policy to adjust gradually public fees and charges to recover costs, the SFC indicated in the last budget exercise its plan to review the level of fees and charges with a view to proposing adjustments in line with the prevailing economic conditions. Following a review in 2000, the SFC has decided to maintain the existing levels of fees and charges for the time being and to re-examine the matter in 2001-02 in anticipation of the implementation of a new licensing regime under the Securities and Futures Bill, which is under examination by the Council.

7. As regards funding by the Government, an annual grant may be given to the SFC as a stable source of income to offset the more volatile income from the levy and from fees and charges. In accordance with FCR(89-90)12, such a grant should be equivalent to the cost to the Government in 1988 of funding the former Office of the Commissioner for Securities and Commodities Trading, less income. The Government will provide the provisional grant at the beginning of each financial year, with a reconciliation and, if necessary, adjustment made for the previous financial year. The grant in 1992-93 amounted to \$60 million.¹ There is also an emergency fall-back whereby the SFC can seek loans with the approval of the Finance Committee to enable the Commission to survive any exceptionally prolonged period of low market activities.

8. Owing to a gradually increasing securities transactions turnover since 1993 and a reasonable level of reserves, the SFC has for the ninth consecutive year not requested for any government grant. As a result, the total grant so far foregone by the SFC amounts to about \$688 million.

BUDGET FOR 2001-02

9. The main features of the 2001-02 budget are as follows –

- (a) Estimated revenue for 2001-02 is \$448 million, which represents about 7.6% or \$37 million **below** the latest estimate for 2000-01 (\$485 million). The reduction is attributable mainly to –
- a reduction in income from fees and charges by 4.5% or \$5.7 million as an expected decrease in corporate finance activities more than offsets an expected increase in the applications for registrations;
 - a reduction in other income by 94% or \$30 million because the sum of \$30 million received in 2000-01 was a one-off recovery of legal costs in relation to a single case; and
 - a reduction in investment income by 15% or \$9 million because of the contraction of the SFC reserves to finance its deficit and the contribution to the Unified Exchange Compensation Fund² (“UECF”) committed in 1998 in relation to the C.A. Pacific default.

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¹ Should a grant be requested for in 2001-02, the grant is estimated to be about \$93 million at current price.

² The UECF is provided for by the Securities Ordinance to cater for claims for compensation by any person who has suffered pecuniary loss as a result of a default on the part of a broker member (now exchange participant) in the SEHK.

- (b) Estimated operating expenditure will be \$473 million, which represents about 14% increase or \$58 million **above** the latest estimates for 2000-01. This is mainly attributable to an increase in personnel expenses by 9% or \$30 million over the latest estimates resulting from five additional headcount, the establishment of a manager trainee programme as a new initiative to groom a professional regulatory team, and a provisional 4.5% salary adjustment in line with current market trend. Other items of major increase include –
- information and systems services (increase by 21% or \$2.3 million) due to the full-year effect of outsourcing the new IT help desk and computer centre operation support service;
 - training and development (increase by 49% or \$2.5 million) due to increased expenses in internship programmes, continuous professional training and maintenance of market knowledge;
 - professional and others (increase by 51% or \$12 million) for projected increase in the demand for external professional services to assist divisions to discharge their functions particularly in view of the impact of market technology on regulation; and
 - the Securities and Derivatives Network (SDNet) project³ (increase by 251% or \$5.7 million) for continuous development of the network.
- (c) An **estimated deficit** of \$52.9 million is expected, as compared with an anticipated surplus of \$49.8 million in the latest estimates for 2000-01.
- (d) As a result, the estimated reserves are expected to fall to \$632 million by the end of the 2001-02 financial year from \$685 million as at the end of the 2000-01 financial year as anticipated in the latest estimates. The estimated reserves (\$632 million) are equivalent to about 15 months of the proposed operating expenditure (including depreciation) for 2001-02.

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³ The SDNet was launched as part of the blueprint envisaged by the Steering Committee on the Enhancement of Financial Infrastructure for upgrading Hong Kong's financial infrastructure. The SDNet is to provide for the setting up of an industry wide *computer* network that will facilitate electronic communication and order routing among market operators, their participants and the regulators.

- (e) Estimated capital expenditure will be \$38 million or 4.4% above the latest 2000-01 estimates. The provisions are mainly to cater for the replacement of furniture (\$4 million), upgrading of office equipment (\$6 million), the development of web-based application systems for various types of licence applications and further enhancement of system infrastructure and knowledge based management (\$25 million).

A projected income and expenditure statement and a projected balance sheet for the year 2001-02 are on pages 4.1 and 4.2 of the Enclosure.

COMPARISON OF THE APPROVED BUDGET WITH THE LATEST ESTIMATES FOR 2000-01

10. The agreement between the Government and the SFC is that the actual total expenditure of the SFC should not exceed the approved budget by more than 10% without the prior approval of the Financial Secretary. The table on page 2.4 of the Enclosure provides a comparison of the approved budget and the latest estimates for 2000-01. The salient features are –

(a) Revenue

The SFC projects that the total revenue would increase by \$52 million, mainly due to an increase in the revenue from fees and charges (\$33 million) as a result of a larger number of applications for registrations and the high level of corporate finance activities, and a one-off recovery of \$30 million of legal costs in a particular case. The above increases are partly offset by a decrease in the income from securities levy (by \$12 million) since the upward adjustment of SFC's share of the levy income from 0.004% to 0.005% took effect from June 2000 instead of April 2000 as assumed in the approved budget.⁴

(b) Operating Expenditure

The total operating expenditure has been projected downward from \$452 million to \$414 million mainly as a result of the reduction in the expenses on –

/premises

⁴ The levy was previously 0.011% of the consideration of transaction and was shared between SFC and SEHK in the ratio of 4:7. Changes were made in 2000 to reduce the rate to 0.01% and to reallocate the levy income between SFC and SEHK on a 50:50 basis (i.e. each getting 0.005 percentage point of the levy). The above amendments were made through the Securities and Futures Commission (Levy) (Amendment) Order 2000.

- premises (by \$4.3 million) as the rental rate was lower than expected;
- professional and other fees (by \$24 million), mainly due to under-spending in legal fees as there are less cases requiring external legal counsel service than that originally expected;
- training and development (by \$6.8 million) partly due to slippage of training and internship programmes; and
- personnel expenses (by \$4.5 million) mainly due to the surge of staff turnover following improvement in the employment market.

The above reduction is partly offset by a slight increase in the expenses on information system services (\$0.8 million) and general office and insurance (\$0.6 million).

Meanwhile, two new expenditure items, namely “external relations” and “SDNet” have been created. The first item is to cater for the promotion of regulatory cooperation with international markets and the Mainland, while the second is for the further development of the SDNet. The provisions for these two items are re-deployed from the allocation under the respective items of “training and development” and “professional and others”.

(c) Capital Expenditure

The estimated expenditure on “furniture and fixtures” and “office equipment” are both revised slightly upward by \$1 million to cater for fitting out costs arising from the first phase of the office renewal programme and replacement of LCD monitors. The increase will be absorbed by contingency provision under capital expenditure and as a result, the latest estimates for capital expenditure for 2000-01 stay in line with the approved estimates.

ADMINISTRATION'S VIEWS

11. The Administration has carefully examined the SFC budget for 2001-02 and is satisfied that the SFC has made efforts to reduce expenditure without undermining the delivery of its services or performance of its regulatory functions.

12. The Administration notes that the Commission will review the structure and level of its fees and charges later in 2001-02 to reflect the principle of full cost recovery as far as possible.

13. Notwithstanding the \$52.9 million deficit in the estimate, the SFC has for the ninth consecutive year decided not to request an appropriation of annual grant from the Government. The budgeted deficit will be absorbed by the SFC's reserves, which are expected to decrease to \$632 million by the end of 2001-02 financial year, or 15 months of the total operating expenditure (including depreciation) for 2001-02. We are agreeable to the approach adopted by the SFC.

14. Under the Securities and Futures Commission Ordinance (Cap. 24), the SFC levies may be reduced if the SFC has accumulated reserves equivalent to twice its annual operating expenses. As the SFC's reserves are below the threshold, there is no plan to review the levies for funding SFC operation in 2001-02.

15. The Administration considers that SFC's financial position remains at a prudential level. The projected deficit should not have any adverse effect on the Commission's normal operations or the performance of its statutory functions.

16. The budget has been tabled at the Legislative Council Panel on Financial Affairs on 7 March 2001 for discussion. Members raised no substantial comments on the budget proposals. The Administration will recommend the budget to the Financial Secretary for approval.
