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For information

Legislative Council
Panel on Financial Affairs

Securities and Futures Commission Budget
for the Financial Year 2004/05

Introduction

This note provides the additional information requested by Members at the meeting of the Panel on Financial Affairs on 1 March 2004 in discussing the Securities and Futures Commission's ("SFC") budget for 2004/05.

Members' requests

2. Members requested the Administration to –

(a) provide details of the two attempts made by the SFC in 1997 and 1998 to adjust the rates of fees and charges to achieve full cost recovery, including the reasons for the adjustments, proposed levels of increases, cost recovery rates resulting from the proposed adjustments, and reasons of rejection by the then Provisional Legislative Council (PLC) on the proposed adjustments; and

(b) explain the mechanism for reduction of levy under section 396 of the Securities and Futures Ordinance (Cap. 571) (SFO); to provide justifications for the existing threshold for reduction of levy and address some members' view that the existing threshold should be lowered to the effect that levy may be reduced if the SFC has accumulated reserves equivalent to or more than its annual operating expenses.

The additional information is provided below.

Proposed adjustment of the rates of fees and charges in 1997

3. On 10 January 1989, the then Governor-in-Council noted that wherever possible, fees and charges for the SFC would be brought up to a level where they recovered the full costs of services[1]. Since its establishment in 1989, the SFC has adhered to the principle of full cost recovery wherever possible, and its fees were adjusted accordingly in 1991, 1992, 1993 and 1994.

4. In 1997, the SFC conducted a review of its fees and charges. The SFC noted that, since the last fee increases in 1994, the inflationary factor had cumulated to about 12% between April 1995 and April 1997, and had gradually eroded the level of cost recovery of SFC services. In order to minimise cross-subsidisation by the investing public (who contributed to the transaction levy) for market intermediaries (who are the direct users of SFC services), the SFC proposed to increase its fees and charges. The Securities and Futures Commission (Fees) (Amendment) Rules 1997 were made by the Chief Executive-in-Council on 26 August 1997. The Rules were laid before the PLC for negative vetting on 10 September 1997.

5. The proposed levels of increase and the cost recovery rates resulting from the proposed adjustments were as follows –

Category of fees	Levels of increases	Cost recovery rates
(1) Fees relating to intermediaries	range from 7% to 11%	Improve from 79% to 83%
(2) Fees relating to investment products and prospectuses	range from 4% to 13%	Improve from 62% to 70%
(3) Fees relating to the corporate finance	range from 7% to 60%	Improve from 19% to 24%

1 See paragraph 4 of PLC brief ref. SU B3/1(96)IX dated 1 September 1997 entitled "Securities and Futures Commission Ordinance (Chapter 24) Securities and Futures Commission (Fees) (Amendment) Rules 1997".

The proposed adjustments took into consideration that it would not be possible to recover full costs in certain Commission services, e.g. those involving compliance and policy related activities which cannot be attributed to any particular market participants.

6. At its sitting of 15 October 1997, the PLC passed a resolution to repeal the Securities and Futures Commission (Fees) (Amendment) Rules 1997. Members were of the opinion that the SFC had huge revenue from transaction levy and reserves and that its operation would not be affected if the fees and charges were frozen at the existing fee level[2].

Proposed adjustment of the rates of fees and charges in 1998

7. The Administration remained of the view that the consideration as set out in paragraph 4 above continued to apply. In order to keep the fees in line with the full cost recovery policy, the SFC proposed to adjust the levels of fees and charges as those proposed under the repealed (Amendment) Rules 1997. The Securities and Futures Commission (Fees) (Amendment) Rules 1998 were made by the Executive Council on 3 March 1998, and were laid before the PLC for negative vetting on 11 March 1998. Following discussion at the subcommittee level, the PLC passed a motion to repeal the Amendment Rules at the sitting on 7 April 1998[3]. Members repeated the same reservations as expressed in October 1997 in objecting the (Amendment) Rules, i.e. given the large revenue from transaction levy and the high level of SFC's reserves, SFC's operation would not be affected if its fees and charges were frozen at the existing levels. In addition, given the change of economic climate in end 1997, Members opined that –

(a) the SFC should not seek to increase fees and charges at a time of an economic downturn; and

(b) the fee increase proposal by the SFC ran counter to the

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2 See record of Provisional Legislative Council sitting on 15 October 1997.

3 See PLC brief ref. SU B3/1(97)X dated 5 March 1998 entitled "Securities and Futures Commission Ordinance (Chapter 24) Securities and Futures Commission (Fees) (Amendment) Rules 1998".

Financial Secretary's stated commitment of freezing most Government fees and charges at their current levels for one year.

Mechanism for reduction of levy

8. Section 396 (1) of the SFO states that, if during a financial year of the Commission, the reserves of the Commission, after deducting depreciation and all provisions, are more than twice its estimated operating expenses for the financial year (i.e. the threshold) and the Commission has no outstanding borrowings, the Commission shall consult the Financial Secretary with a view to recommending to the Chief Executive-in-Council that the rate or amount of a levy be reduced under section 394.

9. The above threshold was first enacted in section 52 of the Securities and Futures Commission Ordinance (SFCO) in 1989 during the inception of the SFC. The policy intention is that the Commission would be funded largely by the markets through fees and charges for the specific services and activities performed by the SFC on a board cost recovery basis, and the transaction levy.

10. Income from levies on stocks and futures contracts trading has been the most important source of income for the SFC. Over the years, it accounted for 55% to 68% of its total revenue. Any fluctuation in income from levies will have a significant impact on the financial position of the SFC. For instance, during the last two financial years (i.e. 2001/02 and 2002/03), the average daily stock market turnover had dropped from the level of $10.96 billion in 2000/01 to $7.95 billion in 2001/02 and $7 billion in 2002/03. As a result of the market downturn during the past two years, the reserves of the SFC were reduced by about $113 million owing to the two consecutive years of deficit. At the same time, the ratio of reserves to annual operating expenses had fallen from 1.61 in 2000/01 to 1.50 and 1.43 in the subsequent two years.

11. The threshold, at its existing level, would enable the SFC to have sufficient reserves to continue its operation during a few years of low

market turnover, thereby minimising the need to resort to the emergency measure to seek funding from the Government, or for the Government to consider increasing the levy rates.

12. Past experience demonstrates that section 52 of the repealed SFCO (now section 396 of SFO) has worked well and provided an effective and reliable automatic adjustment mechanism for the levy rate. It was invoked previously when the SFC reserve level reached twice its operating expenses. For instance, the mechanism was triggered in 1997/98. The SFC transaction levy was then reduced from 0.006% to 0.004%, effective 1 April 1998.

13. It is worth noting that during years of low market turnover, investors would equally be experiencing a difficult time. If the permitted reserves level of the SFC is set too low such that the levy rate had to be raised to help fund the operation of the SFC during such difficult period, investors would be further burdened with an additional cost. In addition, from the administrative and market point of view, it is not advisable to change the levy rate too frequently. However, this could be the unintended consequence if the threshold was reduced.

Financial Services Branch
Financial Services and the Treasury Bureau
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