

## **NOTE FOR FINANCE COMMITTEE**

### **The Budget of the Securities and Futures Commission for the Financial Year 2007-08**

#### **PURPOSE**

In accordance with the consultation procedures agreed with the Legislative Council (LegCo) when the Securities and Futures Commission (SFC) was established<sup>1</sup>, this paper briefs Members on the main features of the budget of the SFC for 2007-08<sup>2</sup>.

#### **BACKGROUND**

2. Section 13(2) of the Securities and Futures Ordinance (Cap. 571) (SFO) requires the SFC to submit estimates of its income and expenditure (the budget) for each financial year to the Chief Executive for approval. The Chief Executive has delegated the authority to the Financial Secretary. In accordance with section 13(3) of the SFO, the Financial Secretary shall cause the budget to be laid on the table of the LegCo. On 2 March 2007, the Administration and the SFC briefed the LegCo Panel on Financial Affairs (FA Panel) on the SFC's proposed budget for 2007-08. A copy of the budget for 2007-08 is at the Enclosure.

Encl.

#### **FUNDING OF THE SFC**

3. Section 14 of the SFO provides that the Government shall allocate funding to the SFC as appropriated by the LegCo. In practice, the SFC has not sought government appropriation since 1993-94<sup>3</sup>. The funding of the SFC basically comes from the market in the form of transaction levies, and fees and charges on services rendered to market operators and participants.

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<sup>1</sup> Members may wish to refer to FCR(89-90)12 for details.

<sup>2</sup> The financial year of the SFC starts on 1 April and ends on 31 March.

<sup>3</sup> The SFC has not sought appropriation since 1993-94 although the SFC ran into deficits in 1998-99, 2001-02 and 2002-03.

4. Over the years, income from levies on securities and futures contracts trading has been the main source of income for the SFC. On 1 December 2006, the levies on securities and futures/options contracts were reduced by 20%. The current rate of levy<sup>4</sup> on securities transactions is 0.004% while the levy on futures/options contracts is \$0.8 or \$0.16 per leviable transaction, depending on the type of contracts. As regards fees and charges, the SFC adopts, to the extent possible, the principle of full cost recovery. The rates of SFC fees and charges have not been revised since 1994<sup>5</sup>.

## **BUDGET FOR 2007-08**

5. The SFC has projected a surplus budget of \$478.52 million for 2007-08. With the projected budget surplus and a reasonable size of reserves, for the fifteenth year in a row, the SFC does not request any appropriation from the LegCo for the 2007-08 budget. The main features of the 2007-08 budget are set out in paragraphs 6 to 13 below.

### *Estimated Revenue*

6. The estimated revenue for 2007-08 is \$1,077.83 million, which is 6.6% lower than the revised estimates for 2006-07, taking into account the following factors –

- (a) notwithstanding an expected increase in turnover, levy income from securities and futures/options contracts is projected to decrease by \$87.82 million (10%) due to the full-year effect of levy reduction on 1 December 2006 (paragraph 4 above), assuming –
  - (i) the transaction levy for securities will remain at 0.004% throughout 2007-08, and the average daily turnover for 2007-08 is \$38 billion. A decrease of \$80.95 million (9.7%) in levy income is expected; and
  - (ii) the transaction levy for futures/options contracts will remain at \$0.8 or \$0.16 (depending on the type of contracts) per leviable transaction throughout 2007-08, and the average daily turnover for 2007-08 is 90 000. A decrease of \$6.87 million (16.1%) in levy income is expected; and

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<sup>4</sup> Under section 394 of the SFO, the Chief Executive in Council may specify the rates of levy for sale and purchase of securities recorded on a recognised securities market or futures contracts traded on a recognised futures market.

<sup>5</sup> Under section 395 of the SFO, the Chief Executive in Council may, after consultation with the SFC, make rules to prescribe fees.

- (b) income from fees and charges is estimated to decrease by \$6.1 million (3.1%) due to a projected decrease in fees income from corporate finance.

### *Estimated Operating Expenditure*

7. The estimated operating expenditure for 2007-08 is \$599.31 million, which is \$44.1 million (7.9%) higher than the 2006-07 revised estimates. The increase is mainly attributable to –

- (a) increase in personnel expenses by \$46.33 million (11.1%) arising from –
  - (i) creation of six new posts to cope with increase in workload in corporate finance matters and regulation of intermediaries, and upgrading of five posts in various divisions to cope with increasing complexities of work and responsibilities (\$6.12 million);
  - (ii) a provision for an average of 5% pay increase (\$21 million) based on market pay trend surveys which suggest that the average pay increase projected for 2007 ranges from 4% to 6.9%;
  - (iii) removal of the cap on the employer's contribution to the occupational retirement scheme (\$9.7 million);
  - (iv) a provision of \$5.41 million as special pay and retention adjustment to staff to address retention problem due to lower-than-market salary level;
  - (v) increase in medical insurance premium (\$2.2 million) based on actual quotes from service providers; and
  - (vi) higher salary costs arising from filling of vacant posts and full-year effect of creation of six posts in 2006-07 (\$1.9 million);
- (b) increase in premises expenses by \$0.44 million (1.2%) in anticipation of increase in rates and electricity charges, and rental increase for the back up office;
- (c) increase in professional and other expenses by \$2.27 million (9%) mainly arising from the expected increase in litigations under the SFO and contingency provision of legal fees for broker failure cases;

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- (d) increase in external relations expenses by \$0.64 million (14.5%) in anticipation of the increase in the costs of overseas visits and to make provision for hosting the Organisation for Economic Co-operation and Development Corporate Governance Roundtable in 2007;
- (e) increase in corporate communications expenses by \$0.65 million (25.4%) to cater for expanded publicity measures;
- (f) increase in information and systems services expenses by \$0.94 million (4.7%) to meet the increased demand for IT support and maintenance services; and
- (g) partly offset by the lapse of non-recurrent funding in 2006-07 (\$10.62 million) for organising the International Organization of Securities Commissions (IOSCO) 2006 Annual Conference, and contributing to the reserve and contingency fund for the Financial Reporting Council.

### *Staff Establishment*

8. The approved establishment of the SFC by the end of 2006-07 is 427 (comprising 419 permanent established and eight temporary established posts). The SFC proposed to create a total of six permanent established posts in 2007-08 (paragraph 7(a)(i) above). The total establishment will become 433 (comprising 425 permanent established and eight temporary established posts) by the end of 2007-08. The six new posts are required in the Corporate Finance Division<sup>6</sup> and Intermediaries and Investment Products Division<sup>7</sup> to cope with increase in workload arising from –

- (a) increase in corporate finance activities especially in handling Initial Public Offerings and structured products applications;
- (b) preparation for the implementation of statutory backing of listing rules;
- (c) new responsibilities under the prospectus regime law reform project and new projects such as listing of overseas companies and Growth Enterprise Market;
- (d) development of Real Estate Investment Trusts and hedge fund industry; and

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<sup>6</sup> Comprising the creation of two Senior Manager and one Manager posts.

<sup>7</sup> Comprising the creation of three Senior Manager posts.

- (e) policy initiatives to further strengthen the regulation of intermediaries.

The detailed justifications are described in paragraphs 10, 11 and 40 (note (v)) of the budget at the Enclosure.

9. The five posts to be upgraded include one Manager Grade and four General Grades posts in various divisions. The SFC explained that upgrading of posts is required due to increase in job complexities. The SFC also considered that the proposed new posts and upgrading are essential to redress the pressure on human resources and cannot be trimmed down through administrative means.

### ***Surplus and Reserves***

10. As at end November 2006, the reserves of the SFC reached \$1,708.69 million, which are 3.04 times of its approved operating expenditure for 2006-07 (\$561.87 million). The SFC estimated that by 31 March 2007, the reserves will reach \$1,812.83 million, which are 3.23 times of the approved operating expenditure for the year.

11. According to section 396 of the SFO, the SFC may consult the Financial Secretary with a view to recommending to the Chief Executive in Council that the rate of levy be reduced if the reserves of the SFC are more than twice its estimated operating expenses for that financial year. The SFC has carried out a review on this. As the levy has just been reduced in December 2006, the SFC does not recommend reducing the levy further for the time being. The SFC is considering possible new initiatives to enhance investor protection and education to make better use of the reserves.

### ***Estimated Capital Expenditure***

12. The capital expenditure budget proposed for 2007-08 is \$17.6 million, which includes –

- (a) a provision of \$10.5 million for various systems development projects;
- (b) a provision of \$5 million for office equipment including PCs and other PC peripherals and software; and
- (c) a provision of \$0.5 million for the replacement of furniture due to wear and tear.

A contingency equal to 10% of the estimated capital expenditure (\$1.6 million) is also included.

13. Projected income and expenditure statement and projected balance sheet for 2007-08 are on pages 5.1 and 5.2 of the budget at the Enclosure.

### **COMPARISON OF THE APPROVED ESTIMATES WITH THE REVISED ESTIMATES FOR 2006-07**

14. The table on page 4.1 of the budget at the Enclosure provides a comparison of the approved estimates and the revised estimates for 2006-07. The main features are set out in paragraphs 15 to 18 below.

#### ***Revenue***

15. The SFC's revenue in 2006-07 has grown significantly, largely as a result of a substantial increase in levy income due to robust market activities. The revised estimated revenue for 2006-07 is \$1,153.45 million, which represents an increase of \$566.28 million (96.4%) over the approved estimates. The revised estimated average daily turnover of the stock market is \$36.4 billion, which is 120.6% higher than the \$16.5 billion average daily turnover assumed in the approved estimates. As for futures/options contracts, the revised estimated daily turnover of the Futures Exchange is 92 042 contracts, which is 53.4% higher than the estimated daily turnover of 60 000 contracts assumed in the approved estimates.

#### ***Operating expenditure***

16. The revised estimated operating expenditure is \$555.21 million, which is slightly lower than the approved estimates by \$6.66 million (1.2%). The decrease is mainly attributable to –

- (a) lower-than-expected expenditure in the organisation of IOSCO 2006 Annual Conference (\$6.2 million); and
- (b) reduced requirements for new services and system improvements for FinNet (\$0.6 million).

*/Surplus .....*

*Surplus*

17. The estimated surplus for the year is now revised upward to \$598.24 million, which is about 23.6 times of the approved estimates.

*Capital expenditure*

18. The total capital expenditure estimate is slightly reduced from \$18.07 million to \$16.93 million.

**CONSULTATION WITH THE FA PANEL**

19. The Administration and the SFC briefed the FA Panel on the SFC's 2007-08 budget on 2 March 2007. Members generally welcomed the SFC's budget and suggested the SFC to closely monitor the accumulated reserves, and where situation permits, the levy rate should be further reduced. Members also raised concerns over the high staff turnover rate and supported the SFC in taking appropriate measures to retain and develop its staff.

**ADMINISTRATION'S VIEWS**

20. The Administration has examined the SFC's budget for 2007-08 and is pleased to note that the SFC has projected a reasonable surplus in the budget, and that the SFC, as in the past 14 years, has not sought appropriation from the LegCo.

21. Having regard to the volatile changes in the securities market and that the levies were only reduced in December 2006, we accept the SFC's recommendation not to further reduce the levy for the time being. That said, we note that the SFC is considering possible new initiatives in the areas of investors protection and education to make better use of the reserves. The SFC will also continue to keep the levy vis-à-vis the reserves level under review.

22. On personnel expenses, we note that the rapid growth of the markets and the robust activities in corporate finance in recent years have put pressure on the SFC's resources. In this connection, we consider that the SFC has exercised vigilant control and prudence in proposing a mild increase in staff establishment to cope with the increase in workload and responsibilities and staff retention problem. The SFC is mindful of the need to continue to exercise vigilant control on staff resources.

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**SECURITIES & FUTURES COMMISSION**  
**PROPOSED ESTIMATES OF INCOME & EXPENDITURE**  
**FOR THE FINANCIAL YEAR 2007/2008**



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## OVERVIEW

Set out below is a summary of the Commission's Budget for 2007/2008. This has been subject to detailed scrutiny by the Commission's Executive, the Budget Committee and the Commission itself and was approved by the Commission on 4 December 2006.

	<u>2007/2008</u>	<u>2006/2007</u>	
	<u>Proposed</u> <u>Estimates</u> <u>HK\$'m</u>	<u>Revised</u> <u>Estimates</u> <u>HK\$'m</u>	<u>Approved</u> <u>Estimates</u> <u>HK\$'m</u>
Revenue	<b>1,077.83</b>	1,153.45	587.17
Operating Expenditure			
Recurrent	<b>599.31</b>	544.59	547.57
Non-recurrent	-	10.62	14.30
Total Operating Expenditure	<b>599.31</b>	555.21	561.87
Surplus	<b>478.52</b>	598.24	25.30
Reserves at beginning of the year	<b>1,812.83</b>	1,214.59	1,080.92
Reserves at end of the year	<b>2,291.35</b>	1,812.83	1,106.22
Capital Expenditure	<b>17.60</b>	16.93	18.07
Headcount			
Permanent established post	<b>425</b>	419	419
Temporary established post – special advisers	<b>2</b>	2	2
Temporary established post – manager trainees	<b>6</b>	6	6

Detailed commentary on the various budget headings is provided in section 4 of this report. We highlight in this section some features of the approach we have taken and key highlights of our Proposed Estimates for 2007/2008.

### Key Features of Budgetary Approach

1. Our 2007/2008 Proposed Estimates have been prepared in line with our policy of tightly controlling all expenditure as befits a publicly funded organization. We have utilised 2006/2007 expenditure levels as a benchmark except in areas where additional resources have clearly been identified as necessary in order to meet our regulatory oversight obligations or to properly support various current initiatives to modify and strengthen the overall regulatory environment.
2. In managing our most significant operating cost of payroll, we continue to pay close attention to the need to demonstrate prudent use of resources as well as the need to maintain sufficiently competitive compensation packages to retain appropriate levels of skilled staff. In determining our packages we benchmark our costs such that we do not exceed levels for comparable staff in the commercial sector.

3. We have assumed that the securities levy rate will remain at 0.004% for the whole of 2007/2008. However, given the significant current and projected reserves, we have commenced a further review of the appropriate levy rate and we will report our views to the Financial Secretary as soon as this is completed. It is therefore possible that a further reduction in levy rates could be considered during this period.
4. Whilst we do not fully recover all of our costs related to activities for which fees are charged we do not propose any changes in fees and charges during 2007/2008. We will review this situation again next year.
5. We have not factored in the full potential resources implications arising from the statutory backing of the HKEx Listing Rules in the 2007/2008 estimates. We have however added one additional headcount to reflect the level of planning already required, and which will continue to be required going forward, to support this initiative. Should the timetable for statutory backing of the Listing Rules accelerate during 2007/2008, we will, if necessary, prepare and submit a supplementary budget to the Financial Secretary for approval.

### **Key highlights of 2007/2008 Proposed Estimates**

#### **Revenue**

6. Estimated Investor Levy revenue for 2007/2008 is based on estimates of market turnover of \$38 billion, which are formulated on the same basis as previous years. The projected outcome for 2007/2008 is a reduction over 2006/2007 as a result of the reduction in levy rate effective 1 December 2006. 2006/2007 was an exception year and achievement of the 2007/2008 budget is subject to variances in local and overseas market/economic performance during that period. However, a variation of \$1 billion/day in the market turnover will impact 2007/2008 levy income by \$19.8 million indicating some embedded capacity to absorb a reasonable slow down in the market should that be required.
7. Fees and charges income during 2006/2007 increased significantly due to volume increases in the underlying work performed and licenses issued. The outcome for 2007/2008 is expected to be 3.1% lower than 2006/2007 at approximately the same level as the 2006/2007 Approved Estimates. However, the 2006/2007 Approved Estimates included \$20 million of allocated dual filing fees from HKEx, which was not in fact received (see also para. 31). Adjusting for this, the Proposed Estimates for fees is 12% higher than the 2006/2007 Approved Estimates confirming the underlying volume growth which has occurred.

#### **Operating Expenditure**

8. The total estimated operating expenditure for 2007/2008 is \$599.31 million, 7.9% (\$44.1 million) higher than the 2006/2007 Revised Estimates of \$555.21 million. This is substantially all explained by an increase in personnel expenses of \$46.33 million (11.1%).

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9. The increase in personnel expenses arises partly from costs that flow through from decisions taken in previous years, partly from increases in underlying prices and partly from decisions taken regarding the level of remuneration and headcount required for 2007/2008. An explanation of each of these underlying causes is set out in para. 40.
10. The Commission has experienced two clear trends in the work it has undertaken in recent years. An increase in volume and an increase in complexity. Each of these has placed pressure on resources and this has resulted in a reallocation of work away from certain areas, in order to cope with immediate issues and to meet performance pledges, and has also been reflected in increased staff turnover.
11. Management requests for six additional headcount and five position upgrades have been critically examined by the Executive and been reduced substantially from the initial levels requested. The remaining requests have been debated and endorsed by the Budget Committee and finally approved by the Commission. The increases in headcount and upgrading of positions (as more fully detailed in notes (v) of para. 40) are therefore the minimum required to redress the current imbalance that has arisen.
12. A provision has been included in the Proposed Estimates for an average pay rise for Commission staff of 5%. This provision is based on information available to us at this time regarding comparable staff in comparable organizations. However, final decisions regarding the level of award to each grade of staff will not be made until early 2007 when further survey data is available. The Executive will then determine the specific awards and a summary will be presented to the Remuneration Committee for discussion and to the Commission for approval.
13. The remuneration of Commission staff was held back during the economic downturn and whilst it has recovered significantly it still lags levels which survey data suggests are appropriate. The suggested pay rise is in line with market and should enable the Commission to hold its position. However, even at this level it will not allow us to close the gap in what has become an extremely competitive market. Failure to provide a reasonable pay-rise, especially at key grades where attrition is highest, could have a significant impact on morale and retention.
14. Changes in other operating costs and capital expenditure are given in section 4 of this paper.

## **ASSUMPTIONS**

### 15. Investor Levy Rate

The Investor Levy Rate – Securities will remain at 0.004% and the Investor Levy Rate - Futures/Options contracts will remain at \$0.8 and \$0.16 (depending on the type of contracts) throughout 2007/2008.

### 16. Market turnover

The daily turnover will average \$38 billion per trading day for the Hong Kong stock market and 90,000 contract for Futures/Options contracts throughout 2007/2008.

### 17. Remuneration Adjustment

A 5% provision is included for general salary increase in the proposed 2007/2008 budget.

### 18. Interest Rate

The average return of dated securities is assumed at 4.3% p.a. and the yield on deposits is assumed to be 4% p.a. for the year 2007/2008.

### 19. Capital Expenditure

It is assumed that the approved estimates of capital expenditure for different capital projects will, as previously, be carried forward until the completion of the projects.

## 3.1

**MANPOWER PLAN – SUMMARY**

20. The preparation of the manpower plan for 2007/2008 is based on our assessment of staff strength required to discharge the Commission's existing regulatory functions, except in those areas where we have clearly identified that additional resources are necessary in order to meet our regulatory oversight obligations or to properly support various current initiatives to modify and strengthen the overall regulatory environment.

Our proposed manpower plan is outlined below:

Division	Function	Establishment Estimates			
		Approved 2006/2007 <i>(Note 1)</i>	Proposed 2007/2008 <i>(Note 2)</i>	Net Change	Position upgrades
CEO's Office	Division Management & Commission Secretariat	11	11	-	
Corporate Finance	Corporate Finance	56	59	+3	2
Intermediaries & Investment Products	Division Management	16	19	+3	2
	Licensing	33	33	-	
	Intermediaries Supervision	66	66	-	
	Investment Products	28	28	-	
Enforcement	Enforcement	93	93	-	1
Supervision of Markets	Supervision of Markets	19	19	-	
	Research	4	4	-	
Legal Services	Legal Services	17	17	-	
Corporate Affairs	Corporate Communications	14	14	-	
	Investor Education & Communications	13	13	-	
	Information Technology	18	18	-	
	Finance & Administration	19	19	-	
	Human Resources & Training & Development	12	12	-	
Permanent Established Posts		419	425	+6	
Temporary Established Posts:	Special Advisers	2	2	-	
	Manager Trainees	6	6	-	
<b>TOTAL</b>		<b>427</b>	<b>433</b>	<b>+6</b>	<b>5</b>

*Note 1 : We do not propose any revision to the establishment as stated in the approved 2006/2007 estimates.*

*Note 2 : The proposed staff complement for 2007/2008 is 425 Permanent Established Posts plus 8 Temporary Established Posts (2 Special Advisers and 6 Manager Trainees) and 24 temporary staff.*

*Separately, 14 executive trainees are included in and funded out of the SFC Executive Trainee Programme under Training and Development expenditure.*

21. Except as noted below we do not propose any increase in the overall headcount of the Commission for 2007/2008.

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22. Three executive posts are proposed for IIP. Two of them will take charge of the development of policy addressing broker misappropriation and monitoring of risky brokers. One executive post will be responsible for dealing with increased workload and complex licensing issues so as to facilitate industry growth and market development. All three additional posts will be included under divisional management for more flexibility in deploying resources within the division.
23. Three executive posts are proposed for CFD to cope with increased workload and in particular priority projects such as the statutory backing of the listing rules, the prospectus regime law reform as well as the listing of overseas companies.

**PROPOSED ESTIMATES OF INCOME AND EXPENDITURE**

24. Following is a summary of major estimate items :-

		(A)	(B)	(C)	(A)-(B) (B)	(B)-(C) (C)
	Para. Ref.	Proposed Estimates For Year 2007/2008 HK\$'000	Revised Estimates For Year 2006/2007 HK\$'000	Approved Estimates For Year 2006/2007 HK\$'000	Proposed Estimates Over/(Under) Revised Estimates %	Revised Estimates Over/(Under) Approved Estimates %
<b>REVENUE</b>						
Investor Levy	27-30					
Securities		753,920	834,873	327,360	(9.7)	155.0
Futures/Options Contracts		35,712	42,585	23,808	(16.1)	78.9
Fees & Charges	31-32	193,700	199,800	193,000	(3.1)	3.5
Investment Income	33-34	91,000	67,700	34,000	34.4	99.1
Other Income	35-36	3,500	8,500	9,000	(58.8)	(5.6)
<b>Total</b>		<b>1,077,832</b>	<b>1,153,458</b>	<b>587,168</b>	(6.6)	96.4
<b>OPERATING EXPENDITURE</b>						
Premises	37-38	36,867	36,427	35,847	1.2	1.6
Personnel Expenses	39-40	462,270	415,943	415,943	11.1	--
Info. & Sys. Services	41	20,964	20,020	20,050	4.7	(0.2)
General Office & Insurance	42-43	7,230	7,565	7,045	(4.4)	7.4
Training & Development	44-45	9,295	9,010	9,170	3.2	(1.7)
Professional & Others	46-47	27,468	25,196	24,621	9.0	2.3
Corporate Communications	48-49	3,190	2,543	3,046	25.4	(16.5)
External Relations	50-51	5,030	4,392	4,250	14.5	3.3
FinNet	52-53	3,000	3,000	3,600	--	(16.7)
Funding for the FRC (annual)	54	2,500	2,500	2,500	--	--
Contingency	55	1,500	1,000	1,500	50.0	(33.3)
Operating Expenditure		579,314	527,596	527,572	9.8	--
Depreciation		20,000	17,000	20,000	17.6	(15.0)
Total Recurrent Expenditure		599,314	544,596	547,572	10.1	(0.5)
Non-recurrent expenditure	56-58	--	10,618	14,300	(100.0)	(25.7)
<b>Total</b>		<b>599,314</b>	<b>555,214</b>	<b>561,872</b>	7.9	(1.2)
<b>SURPLUS</b>		<b>478,518</b>	<b>598,244</b>	<b>25,296</b>	(20.0)	2,265.0
<b>CAPITAL EXPENDITURE</b>						
Furniture & Fixtures		500	500	500	--	--
Office Equipment		5,000	5,640	5,640	(11.3)	--
Vehicles		--	1,000	1,000	(100.0)	--
Computer Sys. Development		10,500	9,290	9,290	13.0	--
Sub-total		16,000	16,430	16,430	(2.6)	--
Contingency		1,600	500	1,643	220.0	(69.6)
<b>Total</b>	59-60	<b>17,600</b>	<b>16,930</b>	<b>18,073</b>	4.0	(6.3)



**INCOME****Annual Grant from Government**

25. S.14 of the Securities and Futures Ordinance provides that: “For each financial year of the Commission, the Government shall pay to the Commission out of the general revenue the moneys appropriated by the Legislative Council for that purpose.” As in previous years, the Commission proposes that the Government do not request any appropriation from the Legislative Council for the financial year 2007/2008. The Commission’s decision is made without prejudice to the funding principles established when the SFC was formed, and has no implications for requests for appropriations in future years.
26. Had a request for an appropriation been made, it would be provisionally assessed at about \$90 million. This assessment is based on the principle that the annual grant would be equivalent to the net cost to Government for funding the former Office of the Commissioner of Securities, adjusted annually from 1988/1989 prices by reference to adjustments in levels of Government civil service salaries, rent and the general rate of inflation in Hong Kong. On this basis, the Commission has foregone annual grants amounting to approximately \$1.2 billion since 1993/94.

**Investor Levy**

27. A summary of the turnover and levy rate assumptions for the 2006/2007 Approved and Revised Estimates and the 2007/2008 Proposed Estimates is given below.

	2006/2007			2007/2008
	Approved Estimates	First 7 months (actual)	Last 5 months (assumption)	Proposed Estimates (assumption)
<b>Securities</b>				
Daily turnover (billion/day)	\$16.5	\$33.9	\$40.0	\$38
Levy rate	0.004%	0.005%	0.005% (Nov 06) 0.004% (from Dec 06)	0.004%
<b>Futures/Options Contracts</b>				
Daily turnover (contracts)	60,000	93,500	90,000	90,000
Levy Rate	\$0.8/\$0.16	\$1/\$0.2	\$1/\$0.2 (Nov 06) \$0.8/\$0.16 (from Dec 06)	\$0.8/\$0.16

28. The Revised Estimates 2006/2007 of Investor Levy – Securities is higher than the Approved Estimates by 155.0% (\$507.51 million) and for Investor levy – Futures and Options by 78.9% (\$18.78 million). These increase are driven firstly by the robust market activities in recent months which have exceeded the assumptions underlying the Approved Estimates. Secondly, the Approved Estimates for 2006/2007 assumed a 20% levy rate reduction effective from 1 April 2006. This reduction was actually implemented with effect from 1 December 2006 which brought an additional \$120.52 million of securities levy income and \$6.32 million of Futures/Options levy income for 2006/2007.

29. The assumed turnover underlying the 2007/2008 Proposed Estimates is based on estimates prepared by our Research Department on a basis consistent with prior years. The estimated levy income is lower than the Revised Estimates 2006/2007 due to the full year effect of the levy rate reduction on 1 December 2006. Levy income from securities is projected to be \$753.92 million, 9.7% (\$80.95 million) lower than the 2006/2007 Revised Estimate and Levy income from futures/options contracts is projected to be \$35.71 million, 16.1% (\$6.87 million) lower.
30. Our projections indicate that, notwithstanding the recent reduction in levy rate, total reserves will remain in excess of twice the estimated annual operating expenditure estimates. We are therefore conducting a further levy review and will submit our recommendation to the Financial Secretary as soon as the review is concluded. As the levy rate amendment, if any, will not be implemented until the necessary legislative procedures are completed, we have assumed for budgetary purposes that the levy rates will remain unchanged for 2007/2008.

### **Fees and Charges**

31. The Revised Estimates of aggregate fees and charges income for 2006/2007 is 3.5% (\$6.80 million) higher than the Approved Estimates. As in prior years the 2006/2007 Approved Estimate included \$20 million contribution from HKEx in respect of dual filing costs. However, this has not been received, since the original three-year agreement with respect to this contribution expired on 1 April 2006, and HKEx have declined to make any further contribution. Actual increases in underlying fee and charges, after adjusting for the effect of the lack of any contribution, were 15.5% (\$26.80 million). This increase arose from higher than expected licensing fee income (\$10.70 million) and a 'real' increase of 40.2% (\$16.50 million) in corporate finance fee income.
32. For 2007/2008 it is proposed that the level of fees and charges levied by the Commission will remain unchanged. On this basis, total fees and charges income is projected to be \$193.70 million, 3.1% (\$6.10 million) lower than the 2006/2007 Revised Estimates but 12% (\$20.70 million) higher than the 2006/2007 Approved Estimates after adjusting for the \$20 million HKEx fees which were not received.

### **Investment Income**

33. The Revised Estimates of Investment income for 2006/2007 is 99.1% (\$33.70 million) higher than the Approved Estimates due to higher interest rates and increased principal arising from greater than forecast increases in reserves. For the remainder of the year, the average return on dated securities and fixed deposits has been assumed to be 4.5% p.a. and 4.2% p.a. respectively.
34. Investment income in the Proposed Estimates 2007/2008 is \$91 million, 34.4% (\$23.30 million) higher than the revised 2006/2007 estimates. This increase is attributable to increases in the sums available for investment as a result of continued growth in the reserves balance. The average rate of return of dated securities is assumed to be 4.3% p.a. and the yield on bank deposits 4% p.a.

**Other Income**

35. Other income for 2006/2007 is revised downward by 5.6% (\$0.50 million) as the registration fees received for the IOSCO 2006 Annual Conference was \$1 million lower than expected. Other income for the next five months is principally recovery from investigation cases and income from FinNet.
36. Other income for 2007/2008 Proposed Estimates represents FinNet service charges (\$1.5 million) and recovery from investigation cases (\$2 million). The estimate has been revised downward by \$5 million compared to the 2006/2007 Revised Estimates as registration fees for IOSCO 2006 Conference were one-off.

**OPERATING EXPENDITURE****Premises**

37. Premises expenses for 2006/2007 are revised upward by 1.6% (\$0.58 million) to cover the actual rates increase levied by Government.
38. Premises expenses for 2007/2008 are comparable to 2006/2007. We expect the rental of our back up office in Kwun Tong (around 2,300 sq. ft.) to be revised from \$5.5/sq. ft. to \$15/sq. ft. following the rent review in September 2007.

**Personnel Expenses**

39. The projected staff complement for 2006/2007 is 419 permanent established posts plus 8 temporary posts (2 special advisers and 6 manager trainees), in line with the 2006/2007 approved establishment. Personnel expenses for 2006/2007 are retained at the approved level.
40. The projected headcount at 31 March 2008 is 433 (425 permanent established posts plus 8 temporary posts), an increase of 6 over the approved establishment for 2006/2007. In addition, we have proposed 5 position upgrades (please refer to *note (v)* for further details). The Proposed Estimates of personnel expenses for 2007/2008 are 11.1% (\$46.33 million) higher than the 2006/2007 Revised Estimates. A breakdown of the underlying sources of this overall increase is set out below:

<b><u>Source of increase in personnel costs</u></b>	<i>HK\$m</i>	<i>% impact</i>	<i>Notes</i>
General pay increase	21.00	5.0 %	i
Removal of ORSO provident fund cap	9.70	2.3%	ii
Special pay / retention adjustment	5.41	1.3 %	iii
Medical insurance premium increase	2.20	0.5 %	iv
Additional headcount and upgrading	6.12	1.5 %	v
Full year effect of 2006/2007 increase in headcount	1.90	0.5 %	vi
<b>Total</b>	<b>46.33</b>	<b>11.1 %</b>	

*Notes*

- i.* The budget includes provision for an average 5% pay increase for Commission staff. This is based on an analysis of current pay scales against market information from external parties including pay consultants and professional associations. Detailed proposals for the allocation of this average pay increase between grades will be formulated in Q1 2007. These proposals will be presented to the Remuneration Committee for discussion and subsequently to the Commission for final approval. The allocations between grades will be determined based on an analysis of external data and in particular pay level surveys by two external consultants (Hay and McLangan), one of which is only received after submission of this budget. The allocation between grades will also take into account the commercial pressure being experienced at each grade as reflected in current turnover rates. As in prior years, it is expected that the rates of increase will be weighted in favour of middle ranking staff where the Commission is experiencing the highest rates of turnover and where market competition is the most acute.
- ii.* The provident fund contribution of the Commissions ORSO scheme was previously capped at \$4,166 per month due to budgetary concerns at the time of its introduction. This was always intended to be temporary and the Remuneration Committee has previously recommended and the Commission Board has endorsed, in January 2000, that this cap be removed and additional contribution be made when budgetary conditions improve. Market survey data has also confirmed that Commission packages lagged the market in this area and the ORSO scheme was unattractive to many staff. The cap was therefore removed in October 2006 with the consequential impact on overall payroll costs.
- iii.* The Commission does not have a general pay review at October each year but a small number of staff were given pay rises as a special pay / retention adjustment in October 2006, or very exceptionally at other times during the year, to address off-market salaries which had retention implications for the staff involved. These were not included in the 2006/2007 budget although the impact has been absorbed in 2006/2007 by savings arising from our inability to fill all vacancies as quickly as possible. \$5.41 million represents the full year effect of these measures.
- iv.* The estimates for 2007/2008 are based on actual (competitive) quotes obtained from our suppliers representing above inflation increases in premium rates.

- v. The projected headcount at 31 March 2008 is 433 (425 permanent established posts plus 8 temporary established posts), an increase of 6 over the 427 approved establishment at 31 March 2007. Three new executive posts are proposed for the Corporate Finance Division to cope with additional workload as well as priority projects including the statutory backing of the listing rules, the prospectus regime law reform and the listing of overseas companies. A further three executive posts are proposed for the Intermediaries and Investment Products Division to deal with increased workload and licensing issues and to take charge of policy development in connection with broker misappropriation and monitoring of risky brokers. In addition, two upgradings are proposed for the Corporate Finance Division, one for the Enforcement Division and two for the Intermediaries and Investment Products Division to cope with increased job complexity in the respective areas. The estimated additional remuneration for all of these requests is \$6.12 million.
- vi. The additional headcount requested in 2006/2007 was not priced for a full year in order to reflect the expected timing of recruitment. This is the full year impact of the additional headcount approved for 2006/2007.

### **Information and Systems Services**

- 41. The revised Information and Systems Services expenses for 2006/2007 are comparable to the approved estimate. For 2007/2008, we project a 4.7% (\$0.94 million) increase, which is mainly due to higher EDP software maintenance costs after the implementation of SAP and additional Microsoft software application support services required plus the expected increase in the costs to secure IT systems contract services from the market.

### **General Office and Insurance**

- 42. General office & insurance expenses for 2006/2007 are 7.4% (\$0.52 million) above the Approved Estimates as a result of one-off Terrorism Insurance to cover the WTO Ministerial Conference together with some one-off office alteration work following the appointment of a the Chairman and a number of executive directors.
- 43. For 2007/2008, General Office and Insurance expenses are expected to be lower than the Revised Estimates by 4.4% (\$0.34 million).

### **Training and Development**

- 44. Including in training and development are training related expenses (in house training, local external training, overseas training and executive development) together with other items such as the SFC executive trainee programme, external entertainment, staff functions and translation services. The budget for training related expenses is kept at \$5 million for 2006/2007 and 2007/2008.

45. The revised 2006/2007 estimate is comparable with the Approved Estimates. For 2007/2008, the slight increase of 3.2% (\$0.29 million) over the 2006/2007 Revised Estimates is attributable to increases in pay levels for executive trainees and higher demand for external translation services.

### **Professional & Others**

46. Professional & others expense for 2006/2007 have been revised upward by 2.3% (\$0.58 million) principally to cover \$2 million increase in external legal fees incurred for brokers' failure cases. In 2006/2007 this has been partially offset in by the savings in recruitment expenses as recruitment costs of the four ED positions were substantially accrued and charged in the 2005/2006 Estimates.
47. Professional and Others expenses for 2007/2008 are higher than the Revised Estimates by 9.0% (\$2.27 million). This increase is principally due to retaining legal fees at the level shown in the Revised Estimates and returning Recruitment fees to a more normal level (but still lower than 2006/2007 Approved Estimates). There were also small increases in other areas e.g. honorarium for the Chairman and external professional fees. All of these changes are summarized in the table below for ease of review.

<i>All figures in HK\$'000s</i>	<b>2006/2007</b>		<b>2007/2008</b>
	<i>Approved Estimates</i>	<i>Revised Estimates</i>	<i>Proposed Estimates</i>
Non-exec. Directors' Fees	1,638	1,926	2,340
Legal fees	9,000	11,000	11,000
External professional Fees	9,000	9,500	9,500
Recruitment	3,100	770	2,200
Others	1,883	2,000	2,428
<b>Total</b>	<b>24,621</b>	<b>25,196</b>	<b>27,468</b>

### **Corporate Communications**

48. Corporate Communications expenses for 2006/2007 have been revised downward by 16.5% (\$0.50 million) mainly due to the deferment of the SFC image-building project (\$200,000) which will now take place in 2007/2008. We have also excluded the printing costs of the Glossary of Securities, Futures and Financial Terms (\$200,000) as the costs were already absorbed in the preceding financial year and the next update/reprint will take place in 2007/2008.
49. Corporate Communications expenses will increase by 25.4% (\$0.65 million) in 2007/2008 over the 2006/2007 Revised Estimates. The increase is due to printing a new version of the Glossary of Securities, Futures and Financial Terms plus provision for the PR programme and publications for the image building project both of which were previously expected to run in 2006/2007 but will now run in 2007/2008 as part of the 2007/2008 business planning exercise. This delay is reflected in savings in 2006/2007 and the 2007/2008 expenses are 4.7% higher than the 2006/2007 Approved Estimates.

### **External Relations**

50. Revised External Relations expenses for 2006/2007 are comparable to the Approved Estimates.
51. External Relations expenses for 2007/2008 are higher than the Revised Estimates by 14.5% (\$0.64 million). The upward revision is principally due to an estimated increase of 10% in commercial airline ticket costs (based on research) plus a small increase in overseas visits including those for the Chairman and a provision for hosting the OECD Corporate Governance Roundtable in 2007.

### **FinNet**

52. FinNet expenses have been revised downward by 16.7% (\$0.60 million) in 2006/2007 due to under-spending in new service and system improvements.
53. The 2007/2008 estimate for FinNet expenses is expected to remain at the same level as 2006/2007.

### **Funding for the Financial Reporting Council (FRC)**

54. The contribution to the annual operating funding of the FRC is kept at \$2.5 million for both 2006/2007 and 2007/2008. The one-off contribution to the reserve and contingency fund of the FRC has been classified as non-recurrent expenditure (see para 56 & 58 ).

### **Contingency**

55. A contingency of \$1 million and \$1.5 million is provided for the rest of the year 2006/2007 and the whole year 2007/2008 respectively to cover unforeseen expenses arising from changes in the operating environment or unforeseen special requirements.

### **Non-recurrent expenditure**

56. There are two non-recurrent operating expenditure items in 2006/2007, namely, the preparation costs for the IOSCO 2006 annual conference and the one-off contribution to the reserve and contingency fund for the FRC. No such item is expected in 2007/2008.
57. The total expenditure of the IOSCO 2006 Annual Conference was \$5.60 million, \$6.20 million lower than the budget of \$11.80 million. Under-spending was mainly due to the lower than expected no. of participants and the sponsorship received for certain social events.

58. Subsequent to the submission of our 2006/2007 Proposed Estimates the Government requested us to increase our contribution to the reserve fund of the FRC by \$2.5 million (in addition to the \$2.5 million already included in the 2006/2007 Proposed Estimates). This request was subsequently approved by the Commission in January 2006 and has been treated as non-recurrent expenditure.

## CAPITAL EXPENDITURE

59. The total capital expenditure estimate for 2006/2007 has been reduced from \$18.07 million to \$16.93 million as a result of the reduction of contingency provision from \$1.64 million to \$0.5 million.

60. The total capital expenditure Proposed Estimates for 2007/2008 are \$17.60 million, 4% (\$0.67 million) higher than the 2006/2007 Revised Estimates. The planned capital expenditure comprises the following:-

- (i) \$0.5 million for replacement of existing loose furniture and fittings due to normal wear and tear;
- (ii) \$5 million for office equipment which covers:
  - a. \$3 million for replacement of obsolete servers and notebook computers, network infrastructure enhancement, purchase of PC peripherals for various systems development project planned for 2007/2008 and an one-off upgrade of LCD monitors as part of the initiative to enhance the workplace for staff;
  - b. \$1.5 million for SAP user licences for the implementation of the Human Capital Management (HCM) module for the whole Commission plus other additional software tools arising from business/regulatory needs; and
  - c. \$0.5 million for replacement of existing office equipment due to obsolescence (\$0.5 million);
- (iii) \$10.5 million for costs relating to systems development projects such as SMARTS CRC sponsorship, SMARTS-futures market, SAP-project portfolio management, Tablet PC for Intermediaries Supervision and Enforcement; and
- (iv) a contingency of \$1.6 million, which, as in prior years, is set at 10% of the projected total capital expenditure.



**SECURITIES & FUTURES COMMISSION  
PROJECTED INCOME & EXPENDITURE STATEMENT  
FOR THE YEAR 2007/2008**

	<b>Proposed Estimates 2007/2008</b>	<b>Revised Estimates 2006/2007</b>
	<b>HK\$</b>	<b>HK\$</b>
<b>INCOME</b>		
Investor Levy - Securities	753,920,000	834,873,000
Investor Levy - Futures/Options Contracts	35,712,000	42,585,000
Fees & Charges	193,700,000	199,800,000
Investment Income	91,000,000	67,700,000
Other Income	3,500,000	8,500,000
Total Income	<u>1,077,832,000</u>	<u>1,153,458,000</u>
<b>EXPENDITURE</b>		
Operating Expenditure	579,314,000	538,214,100
Depreciation	20,000,000	17,000,000
Total Expenditure	<u>599,314,000</u>	<u>555,214,100</u>
<b>RESULT FOR THE YEAR</b>	<b><u>478,518,000</u></b>	<b><u>598,243,900</u></b>

**SECURITIES & FUTURES COMMISSION  
PROJECTED BALANCE SHEET  
FOR THE YEAR 2007/2008**

	<b>Proposed Estimates 2007/2008</b>	<b>Revised Estimates 2006/2007</b>
	<b>HK\$</b>	<b>HK\$</b>
Fixed Assets	<u>20,000,000</u>	<u>27,000,000</u>
Net Current Assets	<u>2,271,355,018</u>	<u>1,785,837,018</u>
Net Assets	<u><u>2,291,355,018</u></u>	<u><u>1,812,837,018</u></u>
Representing :		
Reserves		
Government Start-up Grant	<u>42,840,429</u>	<u>42,840,429</u>
Income & Expenditure Account		
Beginning Balance	1,769,996,589	1,171,752,689
Result for the Year	<u>478,518,000</u>	<u>598,243,900</u>
	<u>2,248,514,589</u>	<u>1,769,996,589</u>
	<u><u>2,291,355,018</u></u>	<u><u>1,812,837,018</u></u>