

Legislative Council Panel on Financial Affairs

Securities and Futures Commission Budget for the Financial Year 2009-10

PURPOSE

The purpose of this paper is to highlight the main features of the budget of the Securities and Futures Commission (“SFC”) for 2009-10.

BACKGROUND

2. Section 13(2) of the Securities and Futures Ordinance (Cap. 571) (“SFO”) requires the SFC to submit the 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 Legislative Council. In line with past practice, the Administration has prepared this paper to brief Members on the main features of the SFC’s budget for 2009-10, a copy of which is attached at the Annex.

FUNDING OF THE SFC

3. Section 14 of the SFO provides that the Government shall provide funding to the SFC as appropriated by the Legislative Council. In practice, the SFC has not requested for appropriation from the Legislative Council since 1993-94. Its funding basically comes from the market in the form of levies, fees and charges.

4. Over the years, levies on securities and futures/options contracts trading have been the main source of income for the SFC. The current rate of levy on securities is 0.004% while the levy on futures and options contracts is \$0.8 or \$0.16 per leviable transaction, depending on the type of contracts.

Budget for 2009-10

5. The SFC has projected a surplus budget of \$697.06 million for 2009-10. With the projected budget surplus and a reasonable size of reserves, for the seventeenth year in a row, the SFC does not request for any appropriation from the Legislative Council for the 2009-10 budget. Having regard to the reserves and in order to relieve the operating costs of intermediaries, the SFC proposes a one-off waiver of the annual licence fees from over 37,000 intermediaries for one year from 1 April 2009. All licensed corporations, registered institutions, responsible officers and representatives will benefit from the scheme, whilst the fees applicable to new licence applications and transfers will remain unchanged. The estimated fees foregone in 2009-10 will be \$138 million.

6. The main features of the 2009-10 budget are set out in paragraphs 7 to 13 below.

(a) Estimated Revenue

7. Taking into account the impact of the waiver of annual licence fees, the estimated revenue for 2009-10 is \$1,513.83 million, which is 14% below the revised estimates for 2008-09, assuming that –

- (a) levy income from securities and futures/options contracts will decrease by \$81.62 million (5.9%), on the basis that the transaction levy for securities will remain unchanged throughout 2009-10, and assuming the average daily turnover is \$63 billion for securities and 130,000 for futures/options contracts; and
- (b) income from fees and charges will be \$149 million (63.9%) lower than the 2008-09 revised estimates, arising from the waiver of annual licence fees from intermediaries for one year and a slow down in market activities.

(b) Estimated Operating Expenditure

8. In view of the recessionary economic outlook, the SFC will adopt the following measures in 2009/10 –

- (a) First, the SFC will freeze the pay for its staff while providing for funds up to the amount required to preserve the real income level for staff below the Director rank.
- (b) Secondly, the SFC will offer a one-year intern programme to 12 graduates to support Government's drive to generate employment opportunities for graduates.

9. Taking the above two measures into account, the estimated operating expenditure for 2009-10 is \$816.77 million, which is \$97.06 million (13.5%) above the 2008-09 revised estimates (\$719.71 million). The increase is mainly attributable to –

- (a) increase in Personnel Expenses by \$48.54 million (9.3%) arising mainly from –
 - (i) a net increase of 29 new posts in various divisions mainly to strengthen the enforcement capabilities and supervision of intermediaries (\$11.2 million);
 - (ii) a provision equivalent to the amount of funds required to preserve the real income level of staff below Director rank, assuming an inflation rate of 2% for 2009-10 (\$5.5 million);
 - (iii) a provision for a one-year intern programme to 12 graduates (\$1.5 million);
 - (iv) full year effect of fixed pay of new recruits joining the SFC in the second half of 2008-09 (\$21.7 million);
 - (v) full year effect of a mid-year salary adjustment made in October 2008 to high performers whose salaries were

out of line with market to address retention problem (\$0.9 million);

- (vi) increase in provision for retirement benefits (\$5.3 million) and increase in insurance premium (\$1.8 million) arising from the increase in number of officers eligible for the benefits;
- (b) increase in Premises Expenses by \$10.1 million (13.5%) arising from the full year effect of the increase in rental of SFC's office at Chater House from July 2008 (\$6.15 million) and to meet a corresponding increase in government rates (\$2.83 million);
- (c) increase in Professional and Other Expenses by \$18.85 million (56%) for engaging external legal assistance to develop the necessary regulatory changes and other matters arising from the Lehman Minibonds incident (\$10 million) and to meet the increase in legal fees arising from an increase in civil and judicial review cases (\$5.4 million) and more consultancy projects (\$3.2 million); and
- (d) increase in Information and Systems Services by \$5.1 million (20.7%) to provide for new subscription to a commodities data provider and to provide for a full scale information security audit.

(c) Staff Establishment

10. The SFC currently has 462 established posts¹. The SFC proposes a net increase of 29 new posts in the budget of 2009-10 (paragraph 9(a)(i) above refers). The new posts are required mainly to cope with the increase in workload in the following areas –

¹ The established posts include 8 temporary established posts of special advisers and management trainees. The total headcount is 507 which includes 23 temporary posts, 14 executive trainees and 8 posts dedicated to investor education initiative for which financial provision had been approved in 2008-09.

- (a) strengthening the monitoring and supervision of brokers and in managing various issues relating to investment products (10 posts);
- (b) enhancing market surveillance capabilities and coping with more criminal prosecutions (8 posts);
- (c) stepping up review of offering documents and surveillance of advertisements of investment products (5 posts); and
- (d) improving the licensing process (5 posts).

(d) Surplus and Reserves

11. As at end December 2008, the reserves of the SFC reached \$4.82 billion which is 6.2 times of its approved operating expenditure for the current financial year (\$779.68 million). The SFC estimates that by 31 March 2009, the reserves will reach \$4.98 billion, which is 6.4 times of the operating expenditure of the 2008-09 approved estimates.

12. 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 or amount of levy be reduced if the reserves of the SFC is more than twice its operating expenses for that financial year. Having regard to the volatile market performance and the expected increase in resources to address challenges in various regulatory issues, the SFC considers that a reduction in levy should not be pursued for the time being. The SFC will continue to closely monitor the level of its reserves.

(e) Estimated Capital Expenditure

13. The total capital expenditure budget proposed for 2009-10 is \$65.51 million, representing an increase of \$17.56 million (36.6%) above the revised estimates for 2008-09. The increase is required to cater for -

- (a) potential system purchase and external consultancy support in relation to the process improvement and change

management initiatives for the licensing processes (\$28 million);

- (b) technological improvement to market surveillance systems, document management system and website revamp (\$19.1 million); and
- (c) replacement of obsolete computer equipment and office equipment (\$9.46 million) and replacement of obsolete office furniture and fixtures (\$3 million).

COMPARISON OF THE APPROVED BUDGET WITH THE REVISED ESTIMATES FOR 2008-09

(a) Revenue

14. The revised estimated revenue for 2008-09 is \$1,759.52 million, representing a 36.6% decrease from the approved estimates² due to the recent downturn of market activities. Income from securities levy is estimated to decrease by \$939.38 million (41.5%). The surplus for the year is estimated to be \$1,039.81 million, which is 47.9% below the approved estimates of \$1,996.46 million.

(b) Operating expenditure

15. The revised estimated operating expenditure is \$719.71 million, which is \$59.97 million (7.7%) below the approved estimates (\$779.68 million). The decrease is mainly attributable to the deferral of the creation of five new posts in the Enforcement Division³, filling of vacancies later than expected and under-spending in other areas.

² The approved estimates for 2008-09 assumed the average daily turnover of securities and futures and options contracts to be \$114 billion and 174,000 respectively.

³ Resources have been approved in 2008-09 for the creation a decision making panel in the Enforcement Division for making disciplinary decisions. The objective is to ensure a proper segregation of the investigative and disciplinary functions in the decision making process.

(c) Capital expenditure

16. The total capital expenditure estimate is expected to decrease from \$52.47 million to \$47.95 million (8.6%) mainly arising from a reduction in contingency provision.

ADMINISTRATION'S VIEWS

17. The Administration has examined the SFC's proposed budget for 2009-10. We note that the SFC has projected a surplus in its budget; and as in the past years, it has not requested for appropriation from the Legislative Council.

18. Having regard to the volatile performance of the securities market, we concur with the SFC that the levy rates should not be revised for the time being. We consider that the proposed one-year waiver of licence fees would be timely to help relieve the cost burden on intermediaries amidst economic downturn. We also consider it important for the SFC to encourage employers to apply the savings from the waiver to staff training and avoid any job cuts.

19. On the increase in personnel expenses, we note that the increasing complexity of our regulatory activities and the global financial crisis could put pressure on the SFC and additional manpower would be required to meet new challenges. At the same time, we note that the SFC has agreed to freeze the pay for its staff, demonstrating its commitment to join hands with the financial markets in riding out the difficult times.

ADVICE SOUGHT

20. Members are invited to note the proposed budget of the SFC for 2009-10.



SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

SECURITIES & FUTURES COMMISSION
BUDGET OF INCOME & EXPENDITURE
FOR THE FINANCIAL YEAR 2009/2010

18 February 2009



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1. **Approach and background to 2009/10 budget**

- 1.1 Each year the budget is prepared based on a policy of tightly controlling all expenditure, as befits a publicly funded organization. Prior year expenditure levels are utilized as a benchmark except in areas where additional resources have clearly been identified as necessary to meet our regulatory obligations or to support initiatives to modify and strengthen the regulatory environment. During the year strict controls are exercised to ensure that costs stay within budget commitments.
- 1.2 The environment in which the budget has been prepared this year acknowledges the fact that many businesses will be carefully reviewing their costs and putting off non-essential expenditure as a result of the recessionary economic environment. In the light of the further declines in the economy since the initial preparation of our budget we have taken the unusual step of reviewing and updating a number of our budget estimates. Changes arising from this exercise, which took place during the first part of February, have been incorporated within the budget estimates presented in this budget book.
- 1.3 However, while many commercial financial sector entities are experiencing a decline in activity, we are experiencing a counter-cyclical increase in our work due to increased risks in the environment which we monitor and regulate. The financial tsunami which has precipitated the depressed economic conditions has thrown up many challenges for us as a regulator and 2009/10 is expected to be an especially challenging year for the Commission.
- 1.4 Certain areas, especially enforcement and supervision activities, are expected to experience significant increases in work load given the challenges that the industry is now facing and will face over the next year, as well as the large number of mis-selling investigations already under way. These areas need additional resources. The in-depth review of the regulatory environment together with the Legco sub-committee investigation can also be expected to absorb considerable resources throughout 2009/10. While most staff level resources for this work will be reallocated from existing capacity, additional external legal assistances will be necessary to supplement internal resources.
- 1.5 In 2008/09 we included provision to engage consultants in an organization-wide review, to identify areas where we could implement more modern and efficient processes to meet the needs of both the market and us as its regulator. This strategic review has been completed and a programme of operational improvements developed. Further provision has been included in this year's budget to implement these strategic initiatives that will enhance the overall operating efficiency and effectiveness of the organisation. Further details are given in para. 4.4.2.
- 1.6 At the time of preparing last year's budget we were discussing an initiative to set up an Investor Education Council ("IEC") with the Government. All expenditure for this proposal was noted separately in our budget as "Funding for the IEC" under the budget heading "Funding to external parties." While the IEC proposal received "in-principle" support of industry representatives and the other three financial regulators in October 2007, there were concerns that it was not an appropriate time to propose the required legislative changes. As a result the IEC plan did not proceed as drafted but instead there was some expansion of the IE efforts of the SFC and an increase in the budgeted expenditure. Since this expenditure remains within the SFC we have now reallocated



the budgeted expenditure shown in last year's budget book to the appropriate operating expenditure subheads. We have also reclassified secondment programme expenses previously grouped under "external relations" to "training & development" to better reflect the nature of the expense as a staff development activity. To facilitate comparison, the prior year approved budget has been restated in the same format as this year. However, the overall approved budget for the prior year has not been changed. A full reconciliation of the presentation last year with this year is attached as Appendix 1.

- 1.7 Finally, in line with Government initiatives to support the economy during this period of economic stress, we have proposed two measures that the SFC can take to assist the securities industry. Firstly we propose granting a one year fee holiday for all annual license fees payable during the year commencing 1 April 2009 (see also 2.6.1 and 4.1.3 below). Secondly we propose to offer 12 new graduates a one year internship at the SFC (see also note (vi) to 4.2.2(b) below).



2. Executive summary

2.1 Set out below is a summary of the Commission's proposed budget for 2009/10. This summary is intended to give an overview of the key factors influencing the Commission's budget for 2009/10. For more detailed explanations reference should be made to sections 3 and 4 of this budget book.

	2009/10	2008/09		Variance			
	Proposed Budget (a) HK\$m	Forecast (b) HK\$m	Approved Budget ¹ (c) HK\$m	vs. forecast		vs. budget	
				d = (a-b) HK\$m	(d/b) %	e = (a-c) HK\$m	(e/c) %
Income	1,513.83	1,759.52	2,776.14	(245.69)	(14.0%)	(1,262.31)	(45.5%)
Expenditure							
- Operating expenditure	812.38	716.82	776.79	95.56	13.3%	35.59	4.6%
- Funding to external parties	4.39	2.89	2.89	1.50	51.9%	1.50	51.9%
Total Expenditure	816.77	719.71	779.68	97.06	13.5%	37.09	4.8%
Surplus for the year	697.06	1,039.81	1,996.46	(342.75)	(33.0%)	(1,299.40)	(65.1%)
Reserves brought forward	4,981.01	3,941.20	3,852.89	1,039.81	26.4%	1,128.12	29.3%
Reserves carried forward	5,678.07	4,981.01	5,849.35	697.06	14.0%	(171.28)	(2.9%)
Capital Expenditure	65.51	47.95	52.47	17.56	36.6%	13.04	24.9%
Headcount	536	507	507	29	5.7%	29	5.7%

Note 1. Refer also to Appendix 1.

2.2 Income

- 2.2.1 2008/09 income is forecast to be 36.6% below budget due to the downturn in stock exchange activity. Expenditure is forecast to be 7.7% below budget mainly due to below budget personnel expenses. This results in forecast reserves of approximately \$5 billion at the end of this financial year.
- 2.2.2 For 2009/10 we project that income will decline further, by \$245.7 million (14.0%), as a result of the granting of a one-off annual fee waiver to existing licensees (see para 4.1.3 below for further details) and lower average daily turnover on the stock and futures exchanges.
- 2.2.3 While income is principally derived from stock market levies and therefore subject to variances in market activity, the level of surplus projected and the substantial reserves that have been accumulated mean that there is no appreciable risk to the SFC's funding sources. Projections based on various 'worst possible' scenarios indicate that, at current levy rates, the SFC will continue to receive sufficient income from levies to fully cover its operating costs even if there is further market downturn.



2.3 Expenditure

Changes in budgeted expenditure levels are explained in detail within the body of this budget book. However, the following table highlights the key areas which contribute to the increase in budgeted expenditure for 2009/10.

	2009/10	2008/09		Variance			
	Proposed Budget	Forecast	Approved Budget ¹	vs. forecast		vs. budget	
	(a) HK\$m	(b) HK\$m	(c) HK\$m	d = (a-b) HK\$m	(d/b) %	e = (a-c) HK\$m	(e/c) %
Personnel expenses	569.06	520.52	576.18	48.54	9.3%	(7.12)	(1.2%)
Information & systems	29.73	24.63	24.01	5.10	20.7%	5.72	23.8%
Professional & others	52.49	33.65	34.25	18.84	56.0%	18.24	53.3%
Depreciation	40.00	31.00	28.40	9.00	29.0%	11.60	40.8%
Other operating costs	125.49	109.91	116.84	15.58	14.2%	8.65	7.4%
Total Expenditure	816.77	719.71	779.68	97.06	13.5%	37.09	4.8%

Note 1. Refer also to appendix 1.

2.3.1 Total expenditure is expected to increase by 13.5% (\$97.06 million). This increase reflects two main factors related to our personnel costs. Firstly the net addition of 29 new positions in 2009/10, principally in enforcement and supervision, to cope with issues arising from the current financial turmoil. Secondly, 8% under budget operating costs in the current financial year reflecting the difficulty we had during the first part of the year in filling many of our staff positions in a tight labour market – staff turnover rose to as high as 18% during 2008. These issues are now being resolved but overall have resulted in under budget personnel costs. Personnel costs in the current financial year have also been reduced by approximately \$7.5 million by deferring the establishment of the decision making panel, included in the current year's budget, until 2009/10. This delayed recruitment in 2008/09 will have a full year's impact in 2009/10 and the comparison of next year's budget to this year's forecast is therefore distorted by our reduced costs in the first half of 2008/09. If compared to last year's budget, the total expenditure budget has increased by only 4.8%, which is substantially explained by increased premises costs following rent reviews during 2008/09, additional funding to Financial Reporting Council (see 4.3.1) and increased professional fees (see also 1.4 and 2.3.4).

2.3.2 Personnel expenses

As more fully explained in section 3, we have proposed a net increase in headcount of 29 full time positions. This represents an increase in total headcount of approximately 5.7% over the 2008/09 approved headcount and forecast headcount at the end of the financial year. Details of these increases are set out within the body of this report (paras. 3.1 to 3.12) but in summary arise from three main factors:

- (a) Strengthening the enforcement and inspection functions to cope with the changed markets, multiple mis-selling actions;



- (b) increased project resources to implement our organizational effectiveness and efficiency initiatives and in particular the licensing process re-engineering project; and
- (c) additional resources applied to the review of offering documents for retail products under the Securities Futures Ordinance and surveillance of advertisements, to address concerns raised following the collapse of Lehman's Brothers.

The 2009/10 Budget is based on an expectation that all staff at Director level and above will not receive any annual increment. A provision of 1% of personnel costs has been included on the assumption that there will be a cost of living adjustment for middle and junior ranking staff (see also 4.2.2).

2.3.3 Information and System Services

Additional focus on the PRC market over the last year, together with a need to monitor new activities e.g. the proposed formation of a Commodities Exchange, have required additional subscriptions for information and market data services from external services providers. Additional resources will also be spent to improve the functionality of our market surveillances systems. Usage of existing systems has also increased significantly given the market volatility and increased monitoring requirements e.g. of short selling.

2.3.4 Professional and others

Professional fees for 2008/09 are expected to be within budget. For 2009/10 provision has been made for a significant increase in external legal fees as the volume of civil and criminal cases we are engaged on remains high with a clear shift towards more civil work which is more expensive. There are also a large number of mis-selling investigations under way which are expected to require significant legal support costs. Provision has also been made to cover external legal assistance for certain proposed regulatory changes and for matters relating to the Minibonds enquiry. The use of external resources will allow us to compress our timetables for developing policy proposals and market consultation documentation, for a number of these changes. Please see 4.2.6 below for further details.

2.3.5 Depreciation

This is driven by both levels and timing of capital expenditure which are more fully explained in para. 4.2.10.

2.3.6 Operating result

A surplus of approximately \$697.1 million is expected to be generated in 2009/10 leaving our overall reserves at \$5.7 billion by the end of that financial year, approximate 7 times our operating costs after depreciation.



Assumptions

2.4 Investor Levy Rates

2.4.1 The levy rate will remain unchanged for the year 2009/10, i.e.

- (a) Investor Levy Rate - Securities, at 0.004% and
- (b) Investor Levy Rate - Future/Options contracts, at \$0.8/\$0.16 per contract.

2.5 Market Turnover

2.5.1 Equity market

- (a) Based on Research Department's latest forecast, the average securities market turnover is assumed to be \$60 billion/day for the remainder of 2008/09 and \$63 billion/day for 2009/10.

2.5.2 Futures and Options market

- (a) The futures and options volume was almost at levels used in our budget for first six months. However, for forecasting purposes we have assumed that volume will drop in line with estimated declines the securities market turnover in the second half of the year. On this basis, futures/options market turnover is assumed to be an average 138,000 contracts per day for the rest of 2008/09 and 130,000 contracts per day in 2009/10.

2.6 Fees and Charges

2.6.1 We propose to introduce a one-year (only) annual fee waiver for licensees for 2009/10. This will apply to all annual fees payable during the year commencing 1 April 2009 subject to conditions that will be announced during March 2009. The underlying rates of fees and charges, which will still apply to all new license applications, are assumed to remain unchanged.

2.7 Interest Rate

2.7.1 The average return on investment of our reserve funds is assumed to be 2.5% p.a. for the year 2009/10.

2.8 Remuneration Adjustment

2.8.1 The budget is prepared on the basis that all staff at Director level and above will receive no salary increment. A provision of 1% of personnel costs has been included on the assumption that there will be a cost of living adjustment for middle and junior ranking staff (see also 4.2.2).



2.9 **Inflation**

2.9.1 Where an estimate of general price level increases is required we have assumed 2%. This is used where we do not have specific data and/or quotes on which to estimate our future costs.

2.10 **Capital Expenditure**

2.10.1 Capital expenditure is budgeted based on the level of expenditure which will be 'committed to' within a financial year. However, actual expenditure incurred will differ from this and the approved estimates of capital expenditure for different capital projects will, as previously, be carried forward until the completion of the projects. The difference between commitment and actual expenditure within a financial year has become more marked as a result of the major efficiency projects being embarked upon which straddle year ends. Refer to 4.4 for more details.



3. **Manpower plan – summary**

- 3.1 The manpower plan for 2009/10 is based on our assessment of the staff strength required to discharge the Commission's regulatory functions. A net increase in approved headcount of 29 full time positions (5.7%) has been included in the 2009/10 budget, the majority of which will be junior staff. These changes are driven by three main factors:
- additional demands and changes in focus arising from the recent financial crisis;
 - resources required to support efficiency and effectiveness initiatives; and
 - a long-term strategy to re-shape staffing structure to develop a more sustainable organization.
- 3.2 The financial tsunami has radically changed the financial environment and highlighted a number of regulatory challenges that need to be addressed. At an operational level the increased stress on financial institutions will require closer monitoring and additional supervision. The fall out of the financial turmoil has already highlighted a number of areas of apparent regulatory breaches and we have already launched a large number of investigations. This comes at a time when our enforcement focus was already moving to more complex and more resource intensive areas e.g. disqualification of directors and insider dealing. To cope with this changed environment additional resources are particularly necessary in our enforcement and inspection functions.
- 3.3 Last year we commenced a wide ranging strategic review of our operational effectiveness. As the first major initiative following this review we commenced a 2 year process re-engineering project for all Licensing related processes and systems. This project is a key priority for 2008/09 and will continue through 2009/10. The project will deliver significant value to the Commission by improving internal efficiency, increasing job satisfaction for staff and significantly improving our external interface with the market. Dedicated resources are being assigned to this project during its implementation phase and additional project management resources are being recruited. Action will be taken on completion of this project to either absorb the project team members through vacancies created by staff turnover and/or re-deploy them to work on planned subsequent projects which flow from the strategic review.
- 3.4 As part of a longer term strategy to develop more talent in-house and to facilitate longer term succession planning, new positions for the 2009/10 financial year will, wherever possible, be created at a junior professional level. This strategy is expected to enhance our internal talent base, enable the creation of more opportunities for our staff to grow and develop, facilitate improved work allocation and therefore job satisfaction and to allow better management of staff turnover.



3.5 Our proposed manpower plan is outlined below:

Division	Function	Headcount				
		Approved 2008/09	Proposed 2009/10	Position upgrades	Net Change	Para /ref
CEO's Office	Division Management & Commission Secretariat	12	11		-1	
	Decision making panel	5	5			3.6
Corporate Finance	Corporate Finance	60	60			
Enforcement	Enforcement	107	115		+8	3.7
Intermediaries Supervision	Intermediaries Supervision	82	92		+10	3.8
Licensing	Licensing	51	56		+5	3.9
Legal Services	Legal Services	19	20		+1	3.10
Policy, China and Investment Products <small>Note 2</small>	Division Management	3	3			
	Policy	7	8		+1	3.11
	China Affairs	3	3			
	Investment Products	41	45		+4	3.11
Supervision of Markets	Supervision of Markets	20	19		-1	
	Research	6	6			
Corporate Affairs	External Relations	36	36			
	Information Technology	18	18			
	Finance & Administration	23	25		+2	3.12
	Human Resources, Training & Development	14	14			
TOTAL		507 <small>Note 1</small>	536	0	29	

- Notes:
1. Includes 8 positions budgeted for the Investor Education Council now incorporated into the External Relations Department headcount. See also Appendix 1.
 2. A Policy, China and Investment Products (PCIP) Division was formed in March 2008. This new division was staffed primarily by redeploying people from the previous Intermediaries and Investment Products (IIP) Division.

3.6 In the 2008/09 budget we included 5 positions for a decision making panel. Given other priorities we have not moved forward with this proposal during the current year and now propose to implement this initiative during 2009/10.

3.7 Two new executive positions are proposed by the Enforcement Division to further develop their market surveillance capacity. These additions are critically important for the Surveillance Team to effectively monitor increasingly sophisticated activities in the



current fragile investment market and are aligned with the implementation of additional surveillance technology which is included in the capital budget. In addition, four new non-executive professionals are proposed for Enforcement to keep abreast of legal changes, systems changes and continuous improvement in communicating our enforcement messages to the market. A further two new administrative positions are proposed by Enforcement to support the criminal/civil case bundles as a result of DOJ criminal work. This will free up time of existing operational staff to cope with increased investigative work-load.

- 3.8 Ten new positions are proposed for Intermediaries Supervision to step up their efforts in monitoring and supervising the increasing number of higher risk brokers as a result of the current economic stress. These additional resources will also be utilized to focus on the various issues that have been highlighted by allegations of large scale mis-selling of investment products and to proactively manage the following market issues:
- An increase in hedge funds moving into non-equity strategies;
 - International brokers and investment banks using licensed corporations to undertake more sophisticated operations; and
 - An increase in Mainland brokers and fund managers setting up their business in Hong Kong and their engagement in cross-border activities.
- 3.9 Five new positions are proposed for Licensing to: (i) replace four managers who have been assigned to work on the Licensing Process Re-engineering Project on a full-time basis; and (ii) one assistant manager to handle priority projects in the Licensing Department.
- 3.10 One new position is proposed for Legal Services to deal with the increase in workload engendered by the greater emphasis on heavyweight civil litigation. There has been a significant increase in the number and range of civil cases in the High Court involving the Commission such as seeking disqualification of directors, seeking injunctions in relation to risky brokers and suspected insider dealing as well as seeking certification of non-compliance with an investigation. There have also been an unprecedented number of judicial reviews over the past year, the trend of which is set to continue.
- 3.11 Five new non-executive junior professional positions are proposed for PCIP, four for Investment Products and one for the Policy Team. In view of the public concerns raised in connection with the Lehman Brothers Minibonds series, additional resources are required to focus on the review of new applications for authorization of offering documents for retail products under the SFO and surveillance of advertisements. The regulatory framework for investment products and product disclosure documents also requires review to address public concerns. One position is proposed to support the Policy Team to manage public consultation and implementation work in respect of the Code on Unit Trusts and Mutual Funds.
- 3.12 One non-executive position is proposed for F&A to provide an additional office assistant to deal with increased office services resulting from the second office location in Li Po Chun Chambers. Another non-executive position is required to handle an increasing volume of financial transactions in the Commission. The cost of this will be partially offset by taking up the accounting work of the Investor Compensation Company Limited which is currently outsourced.



4. Proposed budget of income and expenditure

Following is a summary of major budget items :-

		(A)	(B)	(C)	(A)-(B) (B)	(B)-(C) (C)
	<u>Para.</u> <u>Ref.</u>	Proposed Budget For Year <u>2009/10</u> HK\$'000	Forecast For Year <u>2008/09</u> HK\$'000	Approved Budget For Year <u>2008/09</u> ^(Note 1) HK\$'000	Proposed Budget Over/(under) Forecast %	Forecast Over/(Under) Approved Budget %
<u>INCOME</u>						
Investor Levy	4.1.2					
Securities		1,249,920	1,322,380	2,261,760	(5.5)	(41.5)
Futures/Options Contracts		51,584	60,746	69,043	(15.1)	(12.0)
Fees & Charges	4.1.3	84,000	233,000	215,000	(63.9)	8.4
Investment Income	4.1.4	124,325	139,394	227,120	(10.8)	(38.6)
Other Income	4.1.5	4,000	4,000	3,220	--	24.2
Total		<u>1,513,829</u>	<u>1,759,520</u>	<u>2,776,143</u>	(14.0)	(36.6)
<u>OPERATING EXPENDITURE</u>						
Premises	4.2.1	84,810	74,707	79,901	13.5	(6.5)
Personnel Expenses	4.2.2	569,056	520,518	576,176	9.32	(9.7)
Info. & Sys. Services	4.2.3	29,733	24,633	24,014	20.7	2.6
General Office & Insurance	4.2.4	6,793	6,666	6,713	1.9	(0.7)
Training & Development	4.2.5	6,955	6,254	6,291	11.2	(0.6)
Professional & Others	4.2.6	52,491	33,646	34,251	56.0	(1.8)
External Relations ^(Note 2)	4.2.7	19,540	17,896	17,738	9.2	0.9
FinNet	4.2.8	--	--	120	--	(100.0)
Contingency	4.2.9	3,000	1,500	3,181	100.0	(52.8)
Depreciation	4.2.10	40,000	31,000	28,400	29.0	9.2
Total (1)		<u>812,378</u>	<u>716,820</u>	<u>776,785</u>	13.3	(7.7)
<u>FUNDING TO EXTERNAL PARTIES</u>						
Funding to FRC	4.3.1	4,000	2,500	2,500	60.0	--
Funding to IASC Foundation	4.3.2	390	390	390	--	--
Total (2)		<u>4,390</u>	<u>2,890</u>	<u>2,890</u>	51.9	--
TOTAL EXPENDITURE (1)+(2)		<u>816,768</u>	<u>719,710</u>	<u>779,675</u>	13.5	(7.7)
<u>CAPITAL EXPENDITURE</u>						
Furniture & Fixtures		3,000	15,000	15,000	(80.0)	--
Office Equipment		9,458	13,073	9,000	(27.7)	45.3
Vehicles		--	200	500	(100.0)	(60.0)
Process Review Project		28,000	15,000	15,000	86.7	--
Computer Sys. Development		19,096	3,386	8,200	464.0	(58.7)
Sub-total		59,554	46,659	47,700	27.6	(2.2)
Contingency		5,955	1,291	4,770	361.3	(72.9)
Total	4.4.1-4.4.2	<u>65,509</u>	<u>47,950</u>	<u>52,470</u>	36.6	(8.6)

Note : 1. Comparative figures have been restated to comply with the current year's presentation as was fully explained in para. 1.6.

2. External Relations includes direct costs related to Investor Education



4.1 INCOME

4.1.1 Annual Grant from Government

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 2009/10. 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.

4.1.2 Investor Levy

- (a) We estimate our income from investor levy for the 2008/09 Approved Budget and Forecast and the 2009/10 Proposed Budget based on the following turnover and levy rate assumptions. Having regard to the recessionary economic outlook, uncertainty as to market turnover levels in the near future and the expected increase in deployment of resources to address various regulatory challenges, we do not propose a reduction to the levy rate at this time.

	2008/09			2009/10
	Approved Budget	First 6 months (actual)	Next 6 months (assumption)	Proposed Budget (assumption)
Securities				
Daily turnover (billion/day)	\$114.0	\$74.0	\$60.0	\$63.0
Levy rate	0.004%	0.004%	0.004%	0.004%
Futures/Options Contracts				
Daily turnover (contracts)	174,000	170,000	138,000	130,000
Levy Rate	\$0.8	\$0.8	\$0.8	\$0.8

- (b) The 2008/09 Forecast of Investor Levy – Securities is lower than the Approved Budget by 41.5% (\$939.4 million) and for Investor levy – Futures and Options by 12.0% (\$8.3 million). These decreases reflect the significant drop in market turnover in recent months compared to the estimates underlying the Approved Budget.
- (c) The assumed turnover underlying the 2009/10 Proposed Budget is based on estimates made by our Research Department on a basis consistent with prior years. We project that the average market turnover for 2009/10 will be lower than that of 2008/09 resulting in a further drop in investor levy income by \$81.6 million (5.9%).



4.1.3 Fees and Charges

- (a) The Forecast aggregate fees and charges income for 2008/09 is 8.4% (\$18 million) higher than the Approved Budget. This increase arises from increase in fees and charges income from Licensing.
- (b) The 2009/10 Budget shows a reduction in fee income of 64% against Forecast for 2008/09. This reduction arises from our proposal to provide a one-year annual fee holiday for existing licensees. This initiative is designed to provide the industry with some relief from the regulatory costs of employees. Employers will be encouraged to apply the savings from the fees holiday to training or other direct employee support, during the current economic downturn. This proposal accounts for a reduction of \$138 million in our fee income. We also expect a slow down in market activities from the extraordinary levels seen in early 2008/09 although they are still expected to exceed 2007/08 levels.

4.1.4 Investment Income

- (a) Investment income for 2008/09 is forecast to be \$139.4 million, 38.6% lower than the Approved Budget due to a lower actual rate of return than budget. For the remainder of the year, the average return on dated securities and fixed deposits has been assumed to be 2.5% p.a.
- (b) 2009/10 investment income is budgeted to be \$124.3 million, 10.8% (\$15.1 million) lower than the 2008/09 Forecast. The expected increases in funds available for investment, as a result of continued growth in the reserves balance, is partially off set by the lower rate of return assumed for the whole financial year. The average rate of return is assumed to be 2.5% p.a.

4.1.5 Other Income

- (a) Other income represents net income generated from FinNet, recoveries from investigation cases and sale of SFC publications.

4.2 Operating expenditure

4.2.1 Premises

- (a) Premises expenses for 2008/09 have been revised downward by 6.5% (\$5.2 million) to include the deferred rental incentives and the lower than budgeted management fees for Chater House office.
- (b) Premises expenses for 2009/10 are budgeted to be 13.5% (\$10.1 million) higher than forecast expenses for 2008/09 due to the full year effect of increased rental for Chater House office and higher rates.
- (c) Premises expenses have also been increased by the inclusion of the full cost of 4,500 square feet of surplus space on the 5th floor of Chater House. It was previously proposed that this be sub-let but



given the possibility of either changes to our regulatory role or increase scope of our existing responsibilities in the foreseeable future, the executive proposes to hold this space as available for SFC use for the time being. This will have a cost impact of approximately \$3 million p.a. based on the rental costs of this property.

4.2.2 Personnel Expenses

- (a) After the inclusion of the 8 approved budget positions for the Investor Education Council into the External Relations Department headcount, the approved staff complement for 2008/09 is 507. Overall personnel expenses for 2008/09 are forecast to be lower than budget by 9.7% (\$55.7 million) due to the deferral of formation of the decision making panel until 2009/10, vacancies being filled later than expected and a number of positions being under-filled by lower grades. These latter issues are being addressed and it is expected that they will be resolved by the end of the financial year.
- (b) The projected headcount at 31 March 2010 is 536, a net increase of 29 (5.7%) over the approved headcount included in the 2008/09 budget. Please see paras. 3.7 - 3.12 for an explanation of this increase in headcount. The projected personnel expenses for 2009/10 are 9.3% (\$48.5 million) higher than the 2008/09 Forecast and 1.2% (\$7.1 million) lower than the 2008/09 Budget.

A breakdown of the underlying sources of this overall increase is set out below:

<u>Source of increase in personnel costs</u>	HK\$m	Increase over forecast	% impact	Note
Selective pay awards in 2009/10	5.5	1.0%	11.3%	<i>i</i>
Full year effect of 2008/09 joiners	21.7	4.2%	44.7%	<i>ii</i>
New headcount in 2009/10	11.2	2.1%	23.1%	<i>iii</i>
Retirement benefits	5.3	1.0%	11.0%	<i>iv</i>
Insurance premium increase	1.8	0.4%	3.7%	<i>v</i>
Internship programme	1.5	0.3%	3.1%	<i>vi</i>
Mid-year review flow through	0.9	0.2%	1.9%	<i>vii</i>
Recruitment	0.6	0.1%	1.2%	<i>viii</i>
Total increase over forecast	48.5	9.3%	100%	

Notes :-

- i.* A provision for the annual pay review has been made on the basis that all staff at Director grade and above receive no annual increment in the 2009/10 annual pay awards but that middle and junior grades receive a small cost of living adjustment.



- ii.* This is the full year effect of the remuneration of additional recruits employed during the year. In particular the catch up from the under headcount position experienced in the first half of 2008/09 which has contributed to our under budget costs in the current year.
- iii.* 5 executive positions and 24 non-executive positions are proposed to ensure that the Commission has adequate resources to deliver its priorities in the areas of regulatory reform, enhanced enforcement capabilities and organizational improvements in 2009/10.
- iv.* This represents the increased retirement benefit cost that flows from the increases in underlying fixed pay costs including the provision for new headcount in 2009/10.
- v.* The higher insurance expenses for 2009/10 reflect increases in overall payroll as a result of the proposed increases in salary and headcount. This also reflects proposed rationalisation of contract terms for the remaining employees who are currently on fixed term contracts with reduced benefits. The proposed changes will result in an increase in medical insurance premium due to the inclusion of coverage for their dependents.
- vi.* To support Government initiatives to generate employment opportunities for new graduates, we plan to offer 12 recent graduates a one year internship with the SFC.
- vii.* A small number of mid-year salary adjustments were made for selected high performers in year 2008 to ensure the market competitiveness of their pay levels. The corresponding increase in the 2009/10 budget is due to the full-year effect of such adjustment in 2008/09.
- viii.* Additional recruitment expenses have been provided to cover a possible increase over 2008/09 due to headcount changes and possible search fees for senior staff upon contract renewal in 2009/10.

4.2.3 **Information and Systems Services**

- (a) The Information and Systems Services expenses forecast for 2008/09 are 2.6% (\$0.6 million) higher than the approved budget. This is principally due to a new subscription for WIND, a mainland China news service, together with increased volume of enquiries on Bloomberg related to derivative warrants.
- (b) For 2009/10, we project a 20.7% (\$5.1 million) increase. This includes a new subscription to a Commodities data provider (in anticipation of the formation of a Commodities Exchange), provision for an Commission wide Information Security audit (biannual), further increases in Bloomberg charges for increased enquiries related to derivative warrants etc. and some additional software charges related to the new SMARTS system and SAP.



4.2.4 **General Office and Insurance**

- (a) General Office & Insurance expenses for 2008/09 are on budget at \$6.7 million.
- (b) We expect the same level of expenses for 2009/10 with adjustment for inflation.

4.2.5 **Training and Development**

- (a) Forecast training related expenses for 2008/09 are on budget.
- (b) Training expenses for 2009/10 are 11.2% (\$0.7 million) higher than the Forecast due to the projected increase in headcount plus general inflation in costs. Training for 2009/10 will continue to focus on executive development and talent management.

4.2.6 **Professional & Others**

- (a) Professional & Others expenses for 2008/09 are forecast to be on budget.
- (b) Professional and Others expenses for 2009/10 are expected to increase by \$18.8 million as a result of higher legal fees and external professional service charges.
 - Legal fees are budgeted to be \$15.4 million higher. A provision of \$10 million has been made to cover external legal assistance for certain proposed regulatory changes which have been highlighted in our report to the Financial Secretary on the Lehman's Minibond crisis. In particular the introduction of a single overall product disclosure code and the integration of the Companies Ordinance offering regime into the SFO. The use of external resources will allow us to compress our timetables for developing policy proposals and for preparing necessary market consultation documentation, for these and other regulatory changes. Additional costs are also anticipated for legal advice related to the ongoing Legco sub-committee Minibonds enquiry. The number of civil cases is also expected to increase as we continue to engage in more complex and significant enforcement action.
 - External professional service fees are expected to be \$3.2 million higher due principally to consultancy projects for new initiatives (e.g. consultancy in respect of the development of a gold market in Hong Kong, application for CFTC exemption of local broker commodities trading in the US and a review of Unit Trust Code).

4.2.7 **External Relations**

- (a) Forecast External Relations expenses for 2008/09 are on budget and expenses for 2009/10 have an overall budget increase of 9.2%.



- (b) Investor Education, which is the largest single expense under external relations and which had a significant increase last year, has been budgeted to increase its external direct costs by 11.9%. Notwithstanding this, we anticipate that significant new Investor Education initiatives may be launched in 2009/10 after consultation with the Government. This is expected to be along the lines of the Investor Education Council initiative proposed last year. However, since these discussions have not yet commenced this has not been reflected in this budget.

4.2.8 **FinNet**

- (a) Projected income from network support and network connection is \$2.3 million for 2008/09 against \$1.8 million in the approved budget. Projected FinNet expenses are \$1.2 million, leaving a net surplus of \$1.1 million, which is included as other income (see para. 4.1.5).
- (b) For 2009/10, we have budgeted \$1.9 million for the operating costs of FinNet and estimated income of \$2.3 million, leaving a net surplus of \$0.4 million. Again, this is classified as other income.

4.2.9 **Contingency**

- (a) A contingency of \$1.5 million is provided for the remainder of 2008/09 and \$3 million provided for 2009/10 to cover unforeseen expenses arising from changes in the operating environment or unforeseen special requirements.

4.2.10 **Depreciation**

- (a) Forecast depreciation expense for 2008/09 is expected to be 9% (\$2.6 million) above budget because more-than-expected capital expenditures committed in prior years have been incurred this year.
- (b) We expect that the depreciation expense for 2009/10 will be \$40 million, 29% (\$9 million) higher than the 2008/09 Forecast. This increase is due to increases in capital expenditure in 2009/10 (see section 4.4 below).

4.3 **Funding to external parties**

- 4.3.1 To continue our support for the work of the Financial Reporting Council, the SFC will increase the annual funding from the existing \$2.5 million p.a. to \$4 million p.a. from 2009/10.
- 4.3.2 To continue supporting the work of the International Accounting Standards Committee Foundation the SFC will again provide funding of US\$50,000.

4.4 **Capital expenditure commitment**

- 4.4.1 The total capital expenditure forecast for 2008/09 has been reduced from \$52.5 million to \$48.0 million principally as a result of the reduction of the contingency provision by \$3.5 million.



4.4.2 The total capital expenditure budget commitment for 2009/10 is \$65.5 million, 36.6% (\$17.6 million) higher than 2008/09 Forecast. The increase is mainly attributable to phase two of the process-review project (\$28 million) which is expected to be \$13 million higher than the first phase committed in 2008/09. However, actual expenditure is expected to be spread over several years and \$10 million of the commitment included in the 2009/10 budget will not be incurred until 2010/11. The planned capital expenditure commitment comprises the following:-

Capital Expenditure	Amount HK\$ m	<i>Note</i>
Replacement of obsolete office furniture & fixtures	3.00	<i>i</i>
Office equipment	9.46	<i>ii</i>
Process review project	28.00	<i>iii</i>
Front end technology	19.10	<i>iv</i>
Contingency (10%)	5.95	<i>v</i>
Total	<u>65.51</u>	

Notes :-

- i.* for replacement of obsolete office furniture and fixtures due to normal wear and tear;
- ii.* for office equipment which covers:
 - \$1.7 million for replacement of obsolete office equipment due to normal wear and tear; and
 - \$7.8 million for the investment in storage technology and data base capacity in response to increased market activities plus costs relating to the normal replacement of obsolete servers and computer equipment for the additional headcount.
- iii.* for the potential system purchase/development and external consultancy support costs in relation to the process improvement and change management initiatives for the Licensing processes;
- iv.* for “front-end” technology (e.g. market surveillance systems, SFC website revamp, document management system, etc.) investment to allow the investing public and market participants to have better access and information exchange with the Commission; and
- v.* a contingency of \$6 million, which, as in prior years, is set at 10% of the projected total capital expenditure.



**SECURITIES & FUTURES COMMISSION
PROJECTED INCOME AND EXPENDITURE STATEMENT
FOR THE YEAR 2009/2010**

	Proposed Budget 2009/2010	Forecast 2008/2009	Change over/(under) Forecast 2008/2009	
	HK\$	HK\$	HK\$	%
INCOME				
Investor Levy - Securities	1,249,920,000	1,322,380,000	(72,460,000)	-5.48%
Investor Levy - Futures/Options Contracts	51,584,000	60,746,200	(9,162,200)	-15.08%
Fees & Charges	84,000,000	233,000,000	(149,000,000)	-63.95%
Investment Income	124,325,000	139,394,000	(15,069,000)	-10.81%
Other Income	4,000,000	4,000,000	-	0.00%
Total Income	1,513,829,000	1,759,520,200	(245,691,200)	-13.96%
OPERATING EXPENDITURE				
Premises	84,810,000	74,707,000	10,103,000	13.52%
Personnel Expenses	569,056,000	520,518,000	48,538,000	9.32%
Information & Systems Services	29,733,000	24,632,600	5,100,400	20.71%
General Office & Insurance	6,793,000	6,666,000	127,000	1.91%
Training & Development	6,955,000	6,253,600	701,400	11.22%
Professional & Others	52,491,000	33,646,000	18,845,000	56.01%
External Relations (Note)	19,540,000	17,896,000	1,644,000	9.19%
FinNet	-	-	-	0.00%
	769,378,000	684,319,200	85,058,800	12.43%
Contingency	3,000,000	1,500,000	1,500,000	100.00%
Depreciation	40,000,000	31,000,000	9,000,000	29.03%
Total operating expenditure (1)	812,378,000	716,819,200	95,558,800	13.33%
FUNDING TO EXTERNAL PARTIES (2)	4,390,000	2,890,155	1,499,845	51.89%
Total expenditure (1) + (2)	816,768,000	719,709,355	97,058,645	13.49%
RESULT FOR THE YEAR	697,061,000	1,039,810,845	(342,749,845)	-32.96%
BEGINNING RESERVES	4,981,011,209	3,941,200,364	1,039,810,845	26.38%
ENDING RESERVES	5,678,072,209	4,981,011,209	697,061,000	13.99%

Note: External Relations includes direct costs related to Investor Education



Appendix 1

Reconciliation of presentation of Approved Budget 2008/2009

	2008/2009 Approved Budget HK\$'000 (Per last year's submission)	Allocation of IEC funding (Note 1) HK\$'000	Reclassification (Note 2)	2008/2009 Approved Budget HK\$'000 (Revised presentation)
INCOME				
Investor Levy				
Securities	2,261,760			2,261,760
Futures/Options Contracts	69,043			69,043
Fees & Charges	215,000			215,000
Investment Income	227,120			227,120
Other income	3,220			3,220
Total	<u>2,776,143</u>			<u>2,776,143</u>
OPERATING EXPENDITURE				
Premises	78,480	1,421		79,901
Personnel Expenses	569,927	6,249		576,176
Information & Systems Services	23,958	56		24,014
General Office & Insurance	6,682	31		6,713
Training & Development	5,624	62	605	6,291
Professional & Others	33,631	620		34,251
External Relations	8,863	9,480	(605)	17,738
FinNet	120			120
Contingency	1,500	1,681		3,181
Depreciation	28,000	400		28,400
Total (1)	<u>756,785</u>	<u>20,000</u>		<u>776,785</u>
FUNDING TO EXTERNAL PARTIES				
Funding to FRC	2,500			2,500
Funding to IEC	20,000	(20,000)		-
Funding to IASC Foundation	390			390
Total (2)	<u>22,890</u>	<u>(20,000)</u>		<u>2,890</u>
Total Expenditure (1)+(2)	<u>779,675</u>	-		<u>779,675</u>
SURPLUS	<u>1,996,468</u>			<u>1,996,468</u>
APPROVED HEADCOUNT	499	8		507

Note 1 : To allocate the funding for the IEC to the appropriate operating expenditure subheads of the SFC as the IEC proposal was not approved. This included \$9.48m as direct cost of investor education programmes recorded under External Relations, personnel expenses for 8 new posts at \$6.25m and other administrative overheads of \$4.27m.

Note 2 : To reclassify secondment programme expenses from external relations budget to training and development expenses to better reflect the nature of the expense.