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**Panel on Financial Affairs
Meeting on 1 March 2010**

**Background brief
on the annual budgets of the Securities and Futures Commission**

Purpose

This paper sets out background information about the Securities and Futures Commission (SFC), in particular the arrangements for funding its operation and scrutiny of its annual estimates. This paper also summarizes the main concerns and views expressed by members when the budgets of SFC for the financial years from 2005-2006 to 2009-2010 were discussed by the Panel on Financial Affairs (FA Panel).

Background

Establishment, regulatory objectives and organizational structure

2. Following the stock market crash of 1987, SFC was established under the then Securities and Futures Commission Ordinance (SFCO) in 1989 as the statutory regulator of the securities and futures market. In 2002, ten ordinances including SFCO were consolidated and modernized into the Securities and Futures Ordinance (SFO) (Cap. 571), which came into operation on 1 April 2003.

3. The regulatory objectives of the SFC as prescribed in section 4 of the SFO are to:

- (a) maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- (b) promote understanding by the public of the operation and functioning of the securities and futures industry;

- (c) provide protection for members of the public investing in or holding financial products;
- (d) minimize crime and misconduct in the securities and futures industry;
- (e) reduce systemic risks in the securities and futures industry; and
- (f) assist the Financial Secretary in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

4. Under the SFO¹, the Board of Directors of SFC shall make up of no fewer than eight members and the majority of them must be non-executive directors. All directors of the Board are appointed by the Chief Executive (CE) or the Financial Secretary (FS) with the delegated authority of the CE. The Executive Committee performs administrative, financial and management functions as delegated by the Board of Directors. The internal controls in the SFC are mainly overseen by three committees, namely the Budget Committee, Remuneration Committee and Audit Committee, which review issues and consider matters regarding the annual budget, staff remuneration and auditing respectively. As at 31 March 2009, the total headcount of SFC was 478, consisting of 349 professional staff and 129 support staff². The organizational structure of SFC as at March 2009 is shown in **Appendix I**.

Financial arrangements

5. Section 14 of the SFO provides that the Government shall provide funding to SFC as appropriated by the Legislative Council (LegCo). In practice, SFC has been self-funded through transaction levies and fees charged to market participants since 1993-1994 and thus has not requested for appropriation from LegCo since then. As at end December 2008, the reserves of SFC reached \$4.82 billion, which was 6.2 times of the approved operating expenditure of SFC for 2008-2009.

6. Under section 13(2) of the SFO, SFC is required to submit, not later than 31 December of each year, the estimates of its income and expenditure (budget) for the next financial year³ to CE for approval. In 1995, the CE has delegated the approval authority to FS. Under Section 13(3) of the SFO, FS shall cause the budget as approved pursuant to Section 13(2) to be laid on the table of LegCo. In addition, under Section 15(3) of the SFO, SFC shall send a report on its activities conducted during the previous financial year (i.e. the annual report) to FS, who shall cause a copy to be laid on the table of LegCo as well. In the past five years, the approved budget of SFC was tabled at a Council meeting in April or May⁴ and the annual report

¹ Section 1 of Part 1 of Schedule 2 to the Securities and Futures Ordinance (Cap. 571)

² Page 55 of the SFC Annual Report 2008-09

³ Section 13(1) of the Securities and Futures Ordinance (Cap.571) specifies that the financial year of the SFC commences on 1 April.

⁴ The SFC approved budgets were tabled at the Council meetings on 27 April 2005, 26 April 2006, 18 April 2007, 16 April 2008 and 13 May 2009.

of SFC was tabled at a Council meeting in between May and July⁵. It is a practice for SFC and the Administration to brief the FA Panel in the month of February or March on the SFC budget and other major initiatives proposed for the next financial year.

Deliberations of the FA Panel

7. The following main concerns and views were expressed by members when discussing the budgets of SFC in the past years.

Levies and fees

8. At the Panel meetings on 2 March 2007 and 28 February 2008, some members noted that the reserves of SFC as at December 2007 and December 2008 far exceeded the two-fold threshold⁶ as specified in the SFO, and called on SFC and the Administration to consider waiving or reducing the levies and fees charged to market participants. A member pointed out that intermediaries were required to pay a licensing fee for each type of regulated activities they carried out under the existing licensing regime⁷, instead of paying a single licensing fee under the old licensing regime. The member asked SFC to examine the possibility of simplifying the licensing and fee regime.

9. Regarding transaction levies⁸, SFC advised that there was no absolute requirement that the rates of levy must be adjusted when the reserve had reached the two-fold threshold. SFC had reviewed the rates of levy and agreed with the Administration that the reduction was not appropriate in view of the volatile performance of the market.

10. As for licensing fees⁹, SFC advised that the principle of full cost recovery was adopted. Since the full cost in the provision of licensing services had not been recovered, it would not be appropriate to reduce or waive the licence fees. SFC also advised that under the existing licensing regime, licensees were only required to pay for the types of regulated activities in which they were engaged. The existing licensing

⁵ The SFC annual reports were tabled at the Council meetings on 11 May 2005, 17 May 2006, 6 June 2007, 11 June 2008 and 8 July 2009.

⁶ Under section 396(2) of the Securities and Futures Ordinance (Cap. 571), SFC should consult FS with a view to recommending to the Chief Executive in Council that the rate of levy be reduced if the reserves of SFC had reached a level more than twice its estimated operating expenses for that financial year.

⁷ The existing licensing regime was introduced under the Securities and Futures Ordinance (Cap. 571) and came into operation on 1 April 2003. During the two-year transitional period (1 April 2003 to 31 March 2005), financial intermediaries could convert their licences that were obtained under the old regime. Under the Securities and Futures (Fees) Rules, licensing fees are payable to SFC and, as prescribed in Schedule 3 to the Rules, fees are imposed on the basis of the number of regulated activities.

⁸ Under section 394(1) of the Securities and Futures Ordinance (Cap. 571), a levy at the rate specified by the Chief Executive in Council by order published in the Gazette shall be payable to the SFC by the person so specified by the Chief Executive in Council for the sale and purchase of securities or future contracts.

⁹ Under section 395(1)(a) of the Securities and Futures Ordinance (Cap. 571), the Chief Executive in Council may, after consultation with the SFC, make rules to require and provide for the payment to the SFC of fees.

regime was introduced for the propose of streamlining the procedures for application for licences rather than to increase SFC's revenue.

11. When the SFC budget for 2009-10 was discussed at the Panel meeting on 26 February 2009, members noted that to help relieve the cost burden on intermediaries amidst the economic downturn, SFC proposed a one-off waiver of the annual licence fees for over 37,000 intermediaries, including licensed corporations, registered institutions, responsible officers and representatives, for one year from 1 April 2009.

Employment-related issues and manpower planning

12. At the meeting on 6 March 2006, some members considered that SFC should put in place adequate safeguards to prevent conflict of interest in the post-termination employment of their senior executives. SFC advised that all SFC employees were bound by the statutory provisions on secrecy and conflict of interest under sections 378 and 379 of the SFO. Non-compliance with these statutory provisions would constitute criminal offences. SFC had subsequently provided supplementary information¹⁰ on the policy governing the post-termination employment of SFC's senior executives and details of the cases of post-termination employment of its senior executives in the three years from 2003-2004 to 2005-2006.

13. At the meeting on 2 March 2007, noting that high staff turnover was common in the financial sector at that time, some members expressed concern on whether an average of 5% pay increase proposed by SFC in its 2007-2008 budget would be effective in retaining experienced and high-calibre staff. The members urged SFC and the Administration to ensure that there were adequate manpower resources for the effective performance of the SFC's regulatory functions and the capability to cope with the rapid development of the financial market and new financial products. SFC admitted that there had been a higher staff turnover rate in 2006 when compared with those the years of economic downturn. However, the average staff turnover rate of 13-14% in 2006 was still lower than the average rate in the financial sector which was 18-20%. Apart from the proposed 5% pay increase, SFC had also put in place a number of measures to tackle the problem of staff turnover such as the implementation of a five-day week. SFC assured members that it would keep its manpower provision under review and make necessary adjustments to cope with changing demands of the financial market.

14. Panel members noted that the remuneration package of SFC's staff included fixed and variable pay components. At the meeting on 26 February 2009, some members expressed the view that unlike the staff of financial institutions whose pay was linked to their profit-making ability, SFC's staff was performing regulatory duties and thus should not be eligible for variable pay for doing their work. SFC responded that splitting the remuneration of the SFC staff into two components was a human

¹⁰ LC Paper No. CB(1)1186/05-06(03) on "Policies on remuneration for and post-termination employment of senior executives of the SFC" prepared by SFC dated 27 March 2006

resource management tool to drive staff performance, as the amount of variable pay would hinge on the performance of individual staff members. Nevertheless, the Administration advised that members' concern about the variable pay component could be relayed to the Remuneration Committee of SFC for consideration.

15. While some members expressed support for a net increase of 29 new posts in SFC's 2008-2009 budget, they called on SFC to effectively deploy the additional manpower to vigorously discharge its regulatory and investigatory functions. These members also expressed concern on whether there were adequate resources and necessary expertise in SFC to cope with the significant increase in the volume and complexity of China market-related issues. SFC acknowledged that it was not easy to recruit staff of the right calibre and expertise to take up China-related regulatory affairs. Nevertheless, as a senior member of staff from the China Securities Regulatory Commission was working in SFC on secondment, SFC could avail itself of his knowledge and expertise in Mainland-related regulatory matters. SFC would also strengthen internal staff training in this area.

Investor protection

16. Since financial products were becoming more sophisticated and more risk-prone, a member called on the Government, at the meeting on 28 February 2008, to formulate improvement measures to enhance investors' understanding of the risks involved and to strengthen the regulation of practitioners. SFC advised that they had issued guidelines requiring practitioners to make full and proper disclosure of all the risks and fees involved in the financial products that they recommended to their clients. SFC would regularly monitor the conduct of practitioners and where necessary, would issue additional guidelines and rules to practitioners on sales practices and disclosure requirements. Investor education programmes had also been launched to educate investors of the need to make full assessment of the risks involved before subscribing for the products.

17. At the meeting on 28 February 2008, a member suggested that the Administration should consider adjusting the maximum limit of compensation at \$150,000 per claimant under the Investor Compensation Fund¹¹.

18. Regarding the large number of complaints relating to Lehman Brothers Minibonds and structured financial products following the collapse of Lehman Brothers, some members opined at the meeting on 26 February 2009 that additional manpower resources such as contract or temporary staff should be provided for coping with the increased workload in complaint handling. They urged SFC to make effort to expedite the complaint handling and investigation process to meet public expectations. SFC responded that they would request for additional provisions if additional manpower was required for handling the complaints. SFC had

¹¹ The Investor Compensation Fund was established under the Securities and Futures Ordinance (Cap. 571) in 2003 to provide compensation to investors for losses sustained in the event of defaults by licensed intermediaries and authorized financial institutions.

subsequently provided supplementary information on the progress of its investigation into the Lehman incident and its other enforcement work.¹²

Office premises

19. At the meeting on 28 February 2008 some members suggested that SFC should consider leasing offices in districts with lower office rentals than those in Central, SFC advised that the leases of its offices in both Chater House and Li Po Chun Chamber would be due for expiry in 2013, and SFC would take the opportunity to review its accommodation needs in one go.

Recent development

20. SFC and the Administration will brief the Panel on SFC's budget for the financial year 2010-2011 on 1 March 2010.

Relevant papers

21. The relevant papers are available at the following links:

Minutes of the FA Panel meeting on 7 March 2005 (Paragraphs 5 to 31)
<http://www.legco.gov.hk/yr04-05/english/panels/fa/minutes/fa050307.pdf>

Administration's paper on "Securities and Futures Commission budget for the financial year 2005-06" (Feb 2005)
<http://www.legco.gov.hk/yr04-05/english/panels/fa/papers/fa0307cb1-1020-3e.pdf>

Minutes of the FA Panel meeting on 6 March 2006 (Paragraphs 8 to 24)
<http://www.legco.gov.hk/yr05-06/english/panels/fa/minutes/fa060306.pdf>

Administration's paper on "Securities and Futures Commission budget for the financial year 2006-07" (Feb 2006)
<http://www.legco.gov.hk/yr05-06/english/panels/fa/papers/fa0306cb1-997-3e.pdf>

SFC's letter on "Policies on remuneration for and post-termination employment of senior executives of the SFC" (March 2006)
<http://www.legco.gov.hk/yr05-06/english/panels/fa/papers/facb1-1186-3e.pdf>

Minutes of the FA Panel meeting on 2 March 2007 (Paragraphs 38 to 52)
<http://www.legco.gov.hk/yr06-07/english/panels/fa/minutes/fa070302.pdf>

¹² LC Paper No. CB(1)1173/08-09(04) prepared by SFC

Administration's paper on "Securities and Futures Commission budget for the financial year 2007-08" (Feb 2007)

<http://www.legco.gov.hk/yr06-07/english/panels/fa/papers/fa0302cb1-1007-6-e.pdf>

Minutes of the FA Panel meeting on 28 February 2008 (Paragraphs 24 to 48)

<http://www.legco.gov.hk/yr07-08/english/panels/fa/minutes/fa080228.pdf>

Administration's paper on "Securities and Futures Commission budget for the financial year 2008-09" (Feb 2008)

<http://www.legco.gov.hk/yr07-08/english/panels/fa/papers/fa0228cb1-822-5-e.pdf>

Minutes of the FA Panel meeting on 26 February 2009 (Paragraphs 35 to 46)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/minutes/fa20090226.pdf>

Administration's paper on "Securities and Futures Commission budget for the financial year 2009-10" (Feb 2009)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0226cb1-854-4-e.pdf>

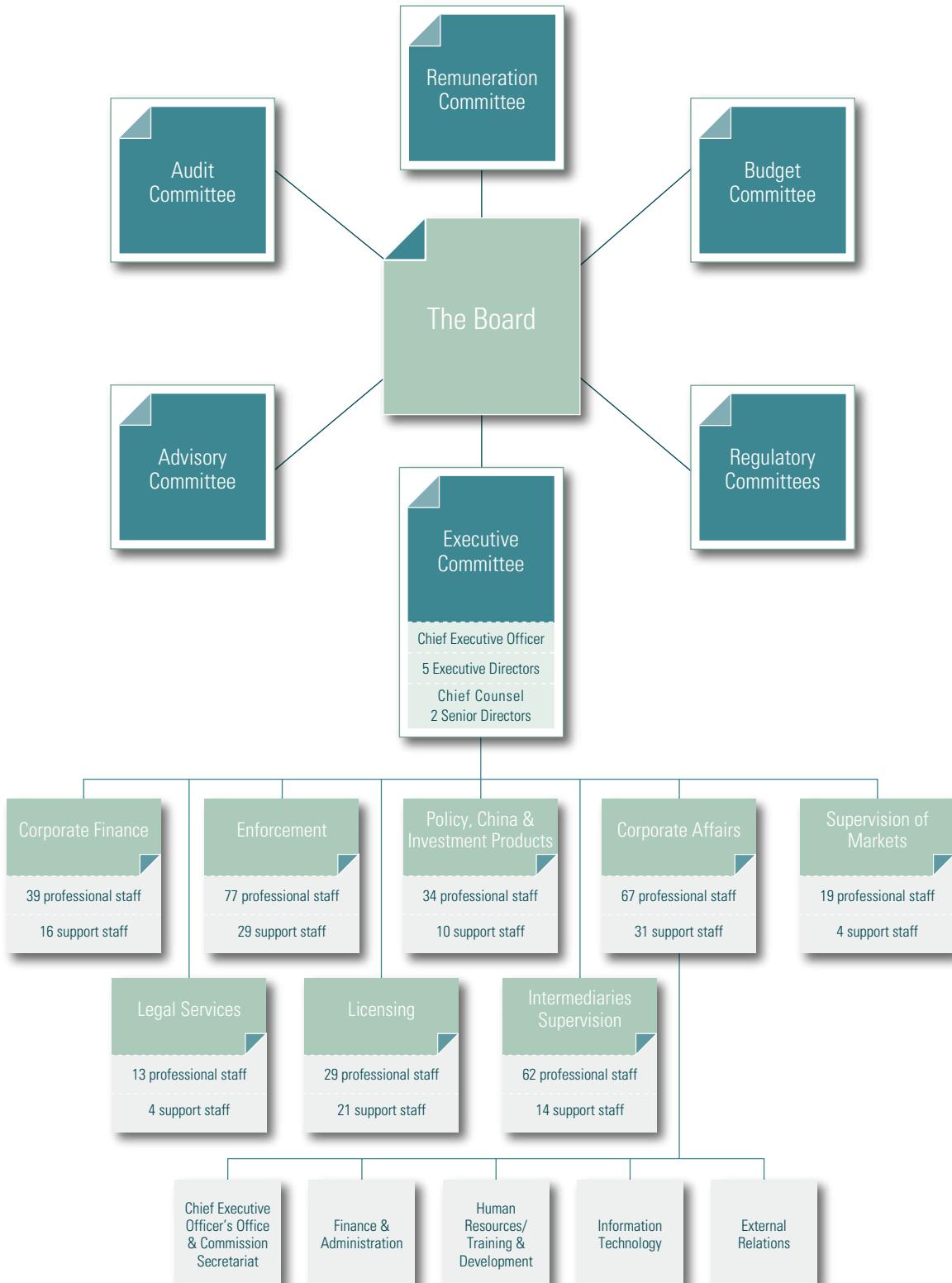
SFC's reply with regard to the number of Lehman-related complaint cases awaiting investigation and related manpower deployment (Feb 2009)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0226cb1-1173-4-e.pdf>

Council Business Division 1
Legislative Council Secretariat
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Our Structure



Note:

SFC has a total headcount of 478 as at March 2009.