

(Extract)

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Panel on Financial Affairs

Minutes of meeting
held on Monday, 7 March 2011 at 10:45 am
in Conference Room A of the Legislative Council Building

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III Budget of the Securities and Futures Commission for the financial year of 2011-2012

(LC Paper No. CB(1)1458/10-11(03) — Administration's paper on "Securities and Futures Commission Budget for the Financial Year 2011-12"

LC Paper No. CB(1)1446/10-11 — Background brief on the annual budgets of the Securities and Futures Commission prepared by the Legislative Council Secretariat)

Briefing by Administration and Securities and Futures Commission

The Principal Assistant Secretary for Financial Services and the Treasury (Financial Services) (PAS(FS)) remarked that the Government supported in principle the proposed budget of the Securities and Futures Commission (SFC) for 2011-2012. The Government noted that SFC had projected a surplus in its budget for 2011-2012, and as in the past years, SFC did not request for appropriation from the Legislative Council.

2. At the invitation of the Chairman, the Chief Financial Officer and Senior Director, Corporate Affairs, Securities and Futures Commission (CFO&SD/SFC) briefed members on SFC's budget for 2011-2012, by highlighting the salient points in the paper.

Discussion

Levies and fees

3. Given that SFC had a reserve of about \$6,700 million and a surplus of about \$700 million in 2010-2011, Mr James TO was of the view that SFC should reduce the level of levies and fees, and should not be responsible for funding the Investor Education Council (IEC) and Financial Dispute Resolution Centre (FDRC). Mr TO opined that in view of the large reserve and surplus, SFC was tempted to increase its staff establishment. While appreciating the need for SFC to increase the salaries of certain grades of existing staff in order to retain them, Mr TO queried the justification for the proposed 61 new posts and the budgeted increase of staff expenses.

4. PAS(FS) responded that the levy on securities transactions had been reduced from 0.004% to 0.003% in 2010-2011. In 2009-2010, in order to help relieve the cost burden on intermediaries amidst the economic downturn, SFC gave a 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.

Regulatory and enforcement work

5. Mr KAM Nai-wai expressed disappointment at the enforcement work of SFC. Mr KAM opined that the enforcement work of SFC lacked transparency. Unlike the Hong Kong Monetary Authority (HKMA) which reported on a weekly basis the progress of its work on Lehman Brothers-related cases, SFC had not disclosed the progress of its investigations on complaints relating to the Lehman-Brothers Minibonds Incident. Instead, SFC had only announced the settlements reached between financial institutions and investors of Lehman Brothers-related retail structured products. Mr KAM remarked that complainants had been advised that SFC was short of manpower in dealing with complaints, despite that there was an increase of 28 and 10 staff in the Enforcement Division of SFC in 2009-2010 and 2010-2011 respectively. Mr KAM enquired whether SFC had invoked the powers under section 107 of the Securities and Futures Ordinance (Cap. 571) (SFO) to instigate proceedings against financial institutions and their staff for mis-selling of Lehman brothers Minibonds.

6. CFO&SD/SFC responded that the provision of manpower for the Enforcement Division, which currently had 125 staff, was based on the estimated workload of the Division. For 2011-2012, SFC had proposed an increase of 15 staff for the Division. If and when necessary, more staff would be proposed for the Division to meet the increase in workload.

7. CFO&SD/SFC further advised that unlike the mode of investigation adopted by HKMA and Police, SFC had adopted a "top down" approach in dealing with the complaints relating to Lehman Brothers-related retail structured products, with a view to securing the largest compensation for the investors concerned within the shortest time. For instance, a settlement agreement had been reached with the Standard Chartered Bank in the previous week to make a payment of about \$1.5 billion to about 2 200 investors. SFC had met the complainants of the Lehman Brother-related retail structured products on an individual basis.

8. Noting that SFC proposed an increase of 15 staff for the Enforcement Division in 2011-2012, Ms Starry LEE enquired whether SFC had any performance pledge for its enforcement work. CFO&SD/SFC replied that SFC had laid down performance pledges, e.g. for handling applications for authorisation for issue of investment products, and handling of enquiries from investors, and the performance pledges, together with the compliance results in the past three years, were published in SFC's annual reports.

9. Ms Emily LAU enquired about the justifications for the proposal to create 15 additional posts in the Enforcement Division. PAS(FS) responded that the number of criminal charges laid by SFC had increased by over 40% last year, in addition to various civil proceedings against directors of listed companies, as well as proceedings before the Market Misconduct Tribunal.

10. Noting that SFC would be the licensing authority for credit rating agencies, Ms Starry LEE enquired about the improvements that would be brought about by the licensing system, in comparison with situation before the global financial crisis. Mrs Regina IP enquired about the steps to be taken to enhance regulation of credit rating agencies and sale of hedge funds.

11. PAS(FS) responded that at present, there were nine types of regulated activities that were subject to the licensing and registration requirements under the SFO. In line with international developments, the Government proposed to subject credit rating agencies to the regulatory regime under the SFO by introducing a Type 10 regulated activity, i.e. providing credit rating services. The relevant subsidiary legislation was being scrutinised by the Legislative Council. In the proposed Budget, the Licensing Department would be given six additional people to handle the significant growth in the number of applications

and duties arising from the new regulatory requirement for credit rating agencies.

12. Mr Albert HO expressed concern that despite the large number of complaints concerning the mis-selling of Lehman Brothers Minibonds by financial institutions, SFC recorded a surplus of about \$700 million in 2010-2011. Mr HO opined that SFC recorded a surplus in 2010-2011 mainly because it had adopted a "top down" approach to seek settlements between banks and complainants, instead of investigating and taking enforcement actions on individual complaint cases, in which there was prima facie evidence of mis-selling of structured products by financial institutions. Many complainants criticised that SFC's enforcement actions were selective, targeting at the small financial institutions rather than the large ones. The public was also dissatisfied that SFC refused to disclose whether a particular case was being investigated or substantiated, or the progress of its investigations under the pretext of secrecy. Mr HO was dissatisfied that SFC even refused to meet complainants and Legislative Council Members to discuss the progress of the investigation of the complaints, in the guise of maintaining its independence. Mr HO pointed out that the levies collected by SFC were authorized by the Legislature and the Government, and were public money, and SFC should be accountable for the use of the levies. Mr HO expressed disappointment at the lack of transparency of the operation of SFC. For instance, SFC had disclosed some of the information of the Citic Pacific case only after Legislative Council Members repeatedly raised questions on the case. Mr HO was dissatisfied that in reply to some complainants in cases where concrete evidence of mis-selling of investment products existed, SFC stated that it had its own strategy in investigation of complaints in view of the lack of manpower. There was not an effective review mechanism in SFC to review individual complaint cases and the actions taken by SFC. He was of the view that the arrogant attitude of SFC could hardly meet the expectations of the public.

13. CFO&SD/SFC responded that SFC fully understood that the levies for funding the SFC were public money, and had exercised vigilant control over the expenditure of the Commission. For 2011-2012, SFC aimed to make use of its financial resources to enhance the protection of investors, including the establishment of the IEC which would help improve investors' knowledge about different investment instruments and their risks. SFC had met Legislative Council Members and answered their queries upon request. In addition to the "top down" approach in handling complaints relating to the Lehman Brothers-related retail structured products, SFC had interviewed individual complainants in the investigation process. Given the high evidence threshold for prosecution actions under section 107 of SFO and the large number of complaints, SFC had to adopt an approach most suitable for

handling the cases. PAS(FS) supplemented that the Process Review Panel of SFC circulated its reports to the Legislative Council on an annual basis. The Government had also given replies to Members' questions raised at Legislative Council meetings about the progress of the investigation into the Citic Pacific case, and prosecution cases under section 107 of SFO. On the transparency issue, SFC had also given details on its enforcement and prosecution actions in its enforcement reporters, quarterly and annual reports, and daily press releases.

14. Mr James TO echoed Mr HO's concern regarding investigation of the Lehman Brothers-related investment product cases. Mr TO expressed dissatisfaction that while recording a surplus in its budget, SFC had adopted a "top down" approach in seeking settlements between financial institutions and complainants, claiming that it lacked the manpower resources to investigate into individual cases. Mr TO opined that SFC should continue to investigate into complaint cases where the complainants and the financial institutions concerned had not reached settlement, and if appropriate, SFC should carry out criminal investigation into the cases by invoking the powers under section 107 of SFO.

15. PAS(FS) responded that the then acting Secretary for Financial Services and the Treasury had already, in her reply to Members' questions at a previous Council meeting, given explanation as to why SFC could not categorically undertake to initiate criminal proceedings under section 107 of SFO as requested by investors of Lehman Brothers-related investment products.

Staff turnover and recruitment

16. In response to Ms Starry LEE's enquiry about the turnover rate of senior and middle level staff in SFC, CFO&SD/SFC stated that SFC had to compete with organizations such as major accounting firms and other corporations for staff with relevant accounting or legal expertise and regulatory experience. The highest turnover rate, ranging from a single digit figure to as high as 25%, was recorded at the junior and middle manager level and a strategic pay adjustment had been proposed for 2011-2012 in order to mitigate the loss of experienced staff and reduce the staff turnover rate.

17. Ms Emily LAU was concerned about the high staff turnover rate of SFC, which stood at about 13 to 14% in 2007, and stood as high as 25% in 2010 for junior and middle level staff.

18. CFO&SD/SFC responded that SFC had closely monitored the staff turnover situation, and reviewed the staff remuneration packages annually in comparison with those in the private sector, with a view to retaining and recruiting adequate qualified middle and lower ranking managers. Apart from review of salaries, SFC also introduced measures to further improve human

resource management, such as providing subsidies for staff to attend job-related training courses. Through a graduate trainee programme, SFC had successfully recruited about 30 fresh graduates in the past two years, with a view to filling the middle and junior manager posts. A part-time staff programme would also be implemented to meet the temporary increases in workload.

Professional and other expenses

19. Noting that "Professional and other expenses" would increase by 28.8% in 2011-2012, Ms Starry LEE enquired about the types of services to be outsourced. CFO&SD/SFC responded that the professional and other expenses included payments for legal advice and expert advice in areas of investigation of misconduct and complaints cases, supervision of intermediaries and regulation of new financial products. The lower expenses in 2010-2011 were mainly due to savings in legal fees arising from legal costs recovered in the year.

Centralised strategy and risk team

20. Ms Starry LEE enquired about the work of the centralised Strategy and Risk team. CFO&SD/SFC remarked that the centralised Strategy and Risk team would comprise a small number of staff including a director, a senior manager and a manager, and would be responsible for strategy and risk management.

Investors Education Council

21. Noting that SFC included a provision of \$10 million as the start-up cost and \$27 million for the operation of the IEC for the first half year, Ms Regina IP enquired, given that since SFC had been performing investor education work in the past, whether the existing staff responsible for investor education work would be transferred to the new IEC.

22. PAS(FS) responded that currently SFC could only carry out investor education work relating to securities and futures according to the SFO. The IEC would provide comprehensive investor education to the public of Hong Kong covering a wide spectrum of financial services such as banking service, insurance service and provident funds. The SFO would be amended accordingly to empower SFC to provide education beyond the scope of securities and futures. IEC would be set up as a company wholly-owned by SFC. A non-executive director of SFC, recommended by the SFC Board and endorsed by the Financial Secretary, will become the Chairman of IEC. The Board of Directors of IEC would include representatives of different regulatory bodies and market people. CFO&SD/SFC supplemented that the existing staff

in the External Relations Department responsible for investor education would be transferred to the IEC.

Staff secondment/attachment arrangements

23. Ms Emily LAU enquired about the staff secondment/attachment arrangements between SFC and the Government.

24. PAS(FS) remarked that at present, a Senior Administrative Officer had been seconded to SFC while two officers from SFC were working in the Financial Services and the Treasury Bureau through an attachment programme. CFO&SD/SFC added that staff attachment had also been arranged between SFC and its counterparts in the Mainland.

Office premises

25. Ms Emily LAU remarked that SFC should consider leasing offices in districts with lower office rentals than those in Central, and enquired if SFC had any plan in this regard. CFO&SD/SFC responded that the leases of SFC's offices in Chater House and Li Po Chun Chambers would expire in 2013 and early 2012 respectively, and SFC would review its accommodation needs in due course.

Resources for new initiatives

26. In response to Mr Albert HO's enquiry as to whether provisions had been included in SFC's budget for implementation of new initiatives, CFO&SD/SFC replied that the Budget for 2011-2012 had not included provisions for new initiatives requiring legislative amendments, such as the statutory codification of the disclosure requirements for price sensitive information of listed companies.

Authorization of structured products

27. The Deputy Chairman remarked that some relevant parties had expressed concern that the process for SFC to authorize the issue of structured products had taken a long time, on an average of about nine months, after the Lehman Brothers Minibonds Incident. The Deputy Chairman enquired whether SFC would consider and discuss with the parties concerned about ways to streamline the authorization process, and/or increase its manpower resources for dealing with the applications.

28. CFO&SD/SFC responded that in view of the complexity of the structured products pending authorization, the significant increase in applications and the need to carefully assess the risks of the structured

products, SFC had proposed additional staff resources for the Policy, China and Investment Products Division in order to expedite the authorization process.

Representation of the Administration/SFC for discussion of SFC's budget

29. Mr James TO remarked that in the discussion of SFC's annual budget, members had expressed concern about the strategy of SFC in handling complaints, especially the "top down" approach in dealing with complaints involving Lehman Brothers-related investment products. Mr TO pointed out that SFC's interviews with the complainants did not involve taking of any statements from the complainants for investigation purpose. In view that the Government was represented by the relevant Directors of Bureaux and heads of departments in Legislative Council meetings for discussion of the Government budget, Mr TO opined that, with due respect to the Government and SFC officers attending the meeting, the Chairman and Chief Executive Officer of SFC should attend the meeting to answer members' questions regarding SFC's budget.

30. Mr LEE Wing-tat and Mr KAM Nai-wai shared Mr James TO's view and suggested that the Chairman and the Chief Executive Officer of SFC should be invited to attend another Panel meeting for further discussion of SFC's budget. Mr KAM said that if the Chairman and Chief Executive Officer of SFC declined to attend the Panel meeting for further discussion of SFC's budget, he would move a motion to reprimand the two officers. Mr LEE opined that there was a lack of transparency, and checks and balances in the operation of SFC, taking into account the fact that the directors of SFC were appointed by the Government and SFC's budget was approved by the Financial Secretary.

Motion moved by Mr James TO

31. Mr James TO moved the following motion:

"本事務委員會將召開特別會議，繼續討論證券及期貨事務監察委員會2011-2012財政年度預算，並邀請證券及期貨事務監察委員會主席及行政總裁出席會議。"

(Translation)

"That this Panel will convene a special meeting to continue the discussion on the budget of the Securities and Futures Commission for the financial year of 2011-2012, and invite the Chairman and Chief Executive Officer of the Securities and Futures Commission to attend the meeting."

32. Mrs Regina IP remarked that if members were dissatisfied with SFC's procedures in investigating complaints and/or taking enforcement actions under section 107 of SFO, rather than the proposed budget, the issues could be pursued separately with SFC, instead of further discussion of the budget. Mrs IP remarked that the procedures for dealing with SFC's budget were much better than that for the HKMA budget, which was not subject to discussion by the Panel. The Deputy Chairman and Mr WONG Ting-kwong expressed concurrence with Mrs IP.

33. Mr KAM Nai-wai and Mr James TO opined that members' concerns about SFC's approach and arrangements for investigation and enforcement work were related to the proposals in the budget.

34. The Chairman put Mr James TO's motion to vote. Of the members present, seven voted for and two members voted against the motion. The Chairman declared the motion passed.

(Post-meeting note: The motion was circulated to members vide LC Paper No. CB(1)1518/10-11 on 8 March 2011. Members were informed vide LC Paper No. CB(1)1571/10-11 on 14 March 2011 that a special Panel meeting would be held on 28 March 2011 to continue discussion of the item.)

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Council Business Division 1
Legislative Council Secretariat
25 March 2011