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Panel on Financial Affairs
Meeting on 6 February 2012

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 2007-08 to 2011-12 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 (Cap. 571) ("SFO"), which came into operation on 1 April 2003.

3. The regulatory objectives of the SFC as prescribed in section 4 of 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 ("FS") in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

4. Under 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 FS with the delegated authority of 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.

5. As at 31 March 2011, the actual staff strength of SFC was 544, consisting of 402 professional staff and 142 support staff. The vacancies were 39 and 4 at the professional and support levels respectively. The organizational structure of SFC as at March 2011 is shown in the **Appendix**.

Financial arrangements

6. Section 14 of 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 on market participants since 1993-1994 and thus has not requested for appropriation from LegCo since then.

7. Under section 13(2) of 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 year² to CE for approval. In 1995, CE has delegated the approval authority to FS. Under section 13(3) of 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 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

¹ Section 1 of Part 1 of Schedule 2 to SFO

² Section 13(1) of SFO specifies that the financial year of the SFC commences on 1 April.

May³ and the annual report of SFC was tabled at a Council meeting in between May and July⁴. 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

8. The major concerns and views expressed by Panel members when FA Panel discussed the annual budgets of SFC for the financial years from 2007-08 to 2011-12 were summarized in the ensuing paragraphs.

Levies and fees

9. 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 threshold⁵ as specified in SFO, and called on SFC and the Administration to consider waiving or reducing the levies and fees charged on market participants. A member also asked SFC to examine the possibility of simplifying the licensing and fee regime.

10. Regarding transaction levies⁶, 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. As for licensing fees⁷, SFC advised that the principle of full cost recovery was adopted.

11. In discussing the SFC budgets for 2009-10 and 2010-11, members noted that SFC proposed a one-off waiver of the annual licence fees for over 37,000 intermediaries for one year from 1 April 2009 and a 25% reduction in levy rates with effect from 1 October 2010⁸ having regard to the size of its reserves⁹.

³ SFC approved budgets were tabled at the Council meetings on 18 April 2007, 16 April 2008, 13 May 2009, 28 April 2010 and 25 May 2011.

⁴ The SFC annual reports were tabled at the Council meetings on 6 June 2007, 11 June 2008, 8 July 2009, 23 June 2010 and 8 June 2011.

⁵ Under section 396(2) of SFO, 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 has reached a level more than twice its estimated operating expenses for that financial year.

⁶ Under section 394(1) of SFO, a levy at the rate specified by the Chief Executive in Council by order published in the Gazette shall be payable to SFC by the person so specified by the Chief Executive in Council for the sale and purchase of securities or future contracts.

⁷ Under section 395(1)(a) of SFO, 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.

⁸ The new levy rates took effect on 1 October 2010 after the enactment of the Securities and Futures (Levy) (Amendment) Order 2010.

⁹ As at end December 2009, the reserves of SFC were about \$5.8 billion, which was 7.3 times of the revised operating expenditure of SFC for 2009-10.

12. In discussing the SFC budget for 2011-12, members noted that SFC had a surplus in 2010-2011 and a large reserve¹⁰, and urged SFC to waive or reduce the transaction levies. SFC responded that in view that a reduction of levies had been implemented since October 2010, SFC had reviewed the situation and did not recommend further reduction of levies in the context of the 2011-12 budget. SFC would conduct a review of the levies in 2011 taking into consideration members' views and SFC's financial situation, and make a proposal to FS by 31 December 2011 regarding the level of levies.

Investment of reserve fund

13. In discussing the SFC budgets for 2010-11 and 2011-12, members expressed concern about the relatively low investment return for the reserves, which was assumed to be 2% for both years. Members enquired whether SFC would consider ways to enhance the investment returns, such as adopting the investment arrangement of the Exchange Fund.

14. SFC responded that it had a statutory obligation to adopt a very cautious investment strategy for the reserve funds. SFC had made proposals to the Government regarding the investment strategy of the reserve funds, and the possibility of outsourcing the investment responsibility to external parties, including the management model of the Exchange Fund.

Staffing issues

Staff turnover and recruitment

15. At the Panel meeting on 1 March 2010, members enquired whether the provision of \$2.5 million for "strategic adjustment"¹¹ had been properly endorsed. SFC responded that its budget had been vetted by the relevant committees and endorsed by the Board of SFC. According to an independent consultant report presented to the Remuneration Committee of SFC, there were a significant number of high performing staff in SFC who were remunerated well below or just at the market rate. Although many investment banks had laid off their staff during the global financial crisis, most of the laid off banking staff were traders and SFC had to compete with the relevant financial institutions for personnel with experience in financial regulatory work. Most vacancies of SFC occurred at the manager and senior manager levels, and its strategy was to build up a bigger pipeline of the junior management grade staff so as to meet the manpower requirements at the middle management level.

¹⁰ As at end December 2010, the reserves of SFC were about \$6.7 billion, which was 7.7 times of the revised operating expenditure of SFC for 2010-11.

¹¹ According to LC Paper No. CB(1)1213/09-10(02) prepared by the Financial Services and the Treasury Bureau, the provision was used to enhance the pay band structure and align salary level of individuals with the market norm.

16. In discussing the SFC budget for 2011-12, members expressed concern about the high staff turnover rate of SFC, which stood as high as 25% in 2010 for junior and middle level staff. SFC responded that it had closely monitored the staff turnover situation, and reviewed the staff remuneration packages annually as appropriate. 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 and the implementation of a graduate trainee programme. The retention rate (94%) for the 30 graduate interns recruited in 2009 and 2010 had been satisfactory.

Manpower plan

17. Noting that SFC proposed an increase of 61 posts in 2011-2012, members sought details and justifications for the proposed staff increase. SFC responded that the additional staff were required to meet the increased volume, scope and complexity of work handled by SFC. The total capitalization of the Hong Kong stock market had nearly doubled in the previous two years and the number of enforcement cases had been increasing in the past years. Seven and 15 additional posts were proposed in the 2011-2012 budget for the Corporate Affairs Division and the Enforcement Division respectively to deal with, among other things, complaints and enforcement cases.¹²

Staff secondment/attachment arrangements

18. At the Panel meeting on 1 March 2010, a member opined that arrangements should be made for government officers to be attached to SFC to enhance the officers' experience in market regulatory work. At the meeting on 7 March 2011, the Administration and SFC advised that 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. Staff attachment had also been arranged between SFC and its counterparts in the Mainland.

Regulatory and enforcement work

19. In discussing the SFC budget for 2011-12, some members questioned the appropriateness of adopting a top-down approach by SFC in handling the complaints relating to Lehman Brothers-related structured products. They enquired whether SFC would co-operate with the Police to investigate into cases which had not been resolved through the settlement arrangement, and where appropriate, take prosecution actions. SFC responded that it would not have been fair to the majority of investors who chose to accept the re-purchase payments if the top-down approach was not adopted and the settlement

¹² SFC provided supplementary information on the proposed staffing increase in 2011-12 vide LC Paper No. CB(1)2060/10-11(01).

agreements with the banks had not been reached. When a settlement had been reached between the investors and the banks concerned, SFC would not continue investigating into the relevant complaint cases relating to the banks. SFC considered that adopting the top-down approach and entering into a settlement between the investors and the banks was a better solution than SFC continuing the investigation of individual cases for a period of time and the investors not knowing whether they would be able to receive any payment. So far SFC had not received any evidence relating to the Lehman Brothers Minibonds Incident which met the threshold for criminal prosecutions under SFO.

20. On some members' concern about the transparency of the operation of SFC, SFC advised that SFC disclosed on a regular basis the outcome of investigation of misconduct cases, including any criminal or civil prosecutions and/or disciplinary actions taken against the parties concerned. For example, the bi-monthly Enforcement Report and the SFC annual report provided statistics on the work of SFC. SFC would not disclose the details of cases before completion of investigation.

Office premises

21. At the meetings on 28 February 2008 and 7 March 2011, 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 expire in 2013 and early 2012 respectively, and SFC would take the opportunity to review its accommodation needs.

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

22. At the Panel meeting on 7 March 2011, some members considered that the Chairman and the Chief Executive Officer of SFC should attend the Panel meeting to answer members' questions on SFC's budget. Pursuant to a relevant motion passed at the meeting, the Panel convened a special meeting on 28 March 2011 to continue the discussion of the budget, and the Chief Executive Officer of SFC attended the meeting.

Recent development

23. SFC and the Administration will brief the Panel on 6 February 2012 on SFC's budget for the financial year 2012-13.

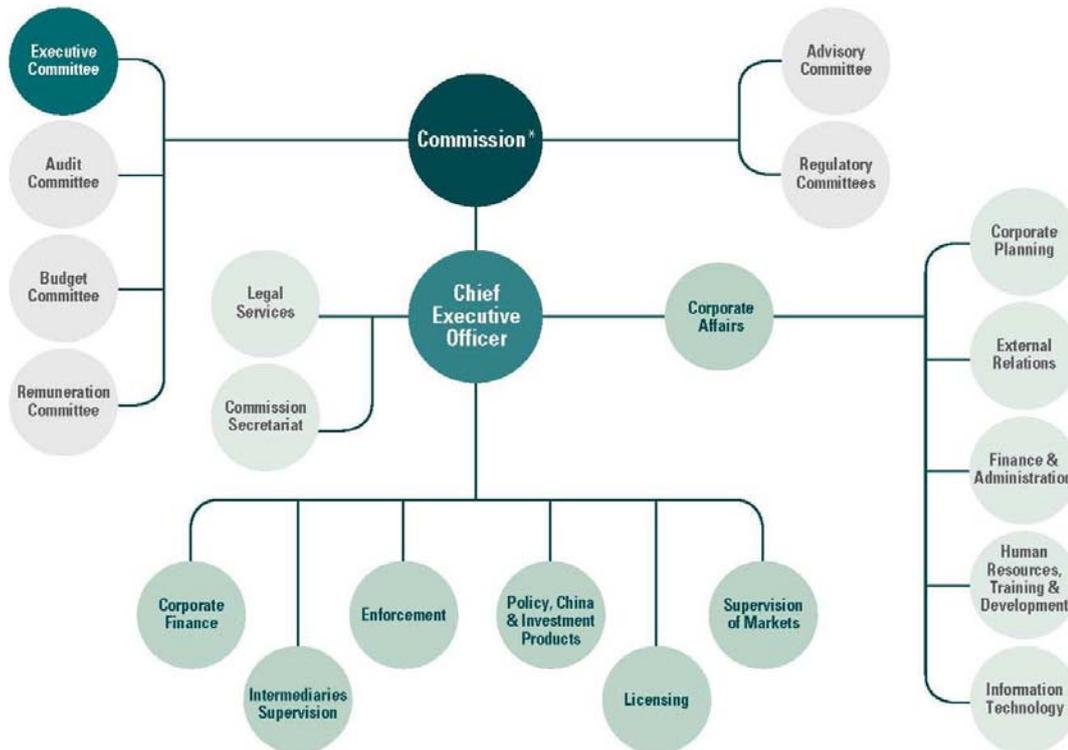
Relevant papers

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

Meeting of the Panel on Financial Affairs on 6 March 2006	Administration's paper Minutes (paragraphs 8-24)
SFC's letter on "Policies on remuneration for and post-termination employment of senior executives of the SFC" (March 2006)	Letter
Meeting of the Panel on Financial Affairs on 2 March 2007	Administration's paper Minutes (paragraphs 38-52)
Meeting of the Panel on Financial Affairs on 28 February 2008	Administration's paper Minutes (paragraphs 24-48)
Meeting of the Panel on Financial Affairs on 26 February 2009	Administration's paper Minutes (paragraphs 35-46)
SFC's reply with regard to the number of Lehman-related complaint cases awaiting investigation and related manpower deployment (February 2009)	SFC's reply
Meeting of the Panel on Financial Affairs on 1 March 2010	Administration's paper Minutes (paragraphs 32-47)
Meeting of the Panel on Financial Affairs on 7 March 2011	Administration's paper Minutes (paragraphs 6-39)
Meeting of the Panel on Financial Affairs on 28 March 2011	Minutes Follow-up paper by SFC
SFC Annual Report 2010-11	Annual Report

Organization structure of the Securities and Futures Commission

Our structure



* The Commission refers to the board of directors.