

NOTE FOR FINANCE COMMITTEE

The Budget of the Securities and Futures Commission for the Financial Year 2013-14

PURPOSE

In accordance with the consultation procedures agreed with the Legislative Council (LegCo) when the Securities and Futures Commission (SFC) was established¹, this note briefs Members on the main features of the budget of SFC for 2013-14².

BACKGROUND

2. Section 13(2) of the Securities and Futures Ordinance (Cap. 571) (SFO) requires SFC to submit estimates of its income and expenditure (the budget) for each financial year to the Chief Executive for approval. The Chief Executive has delegated the authority to the Financial Secretary (FS). In accordance with section 13(3) of SFO, FS shall cause the budget to be laid on the table of LegCo. On 4 February 2013, this Bureau and SFC briefed the Panel on Financial Affairs (FA Panel) on SFC's proposed budget for 2013-14. A copy of the budget for 2013-14 is at Enclosure 1.

Encl. 1

FUNDING OF SFC

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

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

² The financial year of SFC starts on 1 April 2013 and ends on 31 March 2014.

4. Over the years, levies on securities transactions and futures and options contracts trading have been the main source of income for SFC. The current rate of levy³ on securities transactions is 0.003% while that on futures/options contracts is \$0.6 or \$0.12 per leviable transaction, depending on the type of contracts.

BUDGET FOR 2013-14

5. SFC has projected a budget deficit of \$435.16 million for 2013-14. As in past years, SFC does not request any appropriation from LegCo for the 2013-14 budget. The main features of the 2013-14 budget are set out in paragraphs 6 to 18 below.

Income

6. The estimated income for 2013-14 is \$1,065.88 million, which is \$6.29 million (0.6%) above the revised estimates for 2012-13 (\$1,059.59 million), assuming that for 2013-14 the average securities market turnover will be \$54 billion/day, and the average futures/options market turnover will be 238 000 contracts/day.

Expenditure

7. The estimated expenditure for 2013-14 is \$1,501.04 million, which is \$209.33 million (16.2%) above the revised estimates for 2012-13 (\$1,291.71 million). The increase is mainly attributable to –

- (a) increase in staff cost by \$157.76 million (19.8%) arising mainly from –
 - (i) a provision of \$50.10 million for 47 new headcounts to step up core enforcement and supervisory capacity, to address the growing volume and complexity of market conduct issues, as well as to deal with various regulatory issues;
 - (ii) a provision of \$42.90 million for annual pay adjustment, i.e. an amount equivalent to 5.5% of personnel costs; and
 - (iii) a provision of \$14.04 million as “special pay adjustment” for high performing staff with retention risk;

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³ Under section 394 of SFO, the Chief Executive in Council may specify the rates of levy for sale and purchase of securities recorded on a recognised securities market or futures contracts traded on a recognised futures market.

- (b) increase in expenses on “professional and others” by \$32.40 million (56.5%) as SFC does not project any significant recovery of legal costs and the demand for external legal and expert services remains high, especially in the areas of investigation, supervision of intermediaries and authorisation of new products;
- (c) increase in expenses on “information and systems services” by \$6.32 million (14.2%) due to higher software and hardware maintenance costs after the lapse of the warranty period and increases in subscriptions for market data to support enforcement and supervision activities; and
- (d) increase in funding to external parties by \$12.43 million (25.6%). This is attributable to the full-year effect of funding for the Investor Education Centre (IEC)⁴ and the continued support for the work of the Financial Reporting Council, the Financial Dispute Resolution Centre, the International Financial Reporting Standards Foundation and the development of a Hong Kong XBRL⁵ taxonomy⁶.

Manpower Plan

8. SFC approved an interim request of 35 additional posts in 2012-13 to support work resulting from new and proposed legislations, the establishment of a Risk and Strategy Unit as well as International and China Unit. These initiatives include (a) the implementation of a statutory disclosure regime for price sensitive information; (b) the institution of proceedings before the Market Misconduct Tribunal by SFC direct; (c) the development of new rules for the regulation of the over-the-counter derivatives market in Hong Kong; and (d) the development of new rules for a sponsor regime for initial public offerings. With this interim headcount addition, SFC now has a total headcount of 743⁷. SFC proposes an additional 47 new posts in the budget of 2013-14, and the total headcount will be 790⁷. The new positions are required mainly to cope with the increase in workload in the following areas –

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⁴ IEC commenced operation on 20 November 2012.

⁵ XBRL (Extensible Business Reporting Language) is an open standard that is developed and maintained by XBRL International, a global non-profit consortium of over 650 major companies, organisations and government agencies from 30 countries, including China, the UK and the US. It aims at standardizing financial reporting in order to promote transparency and improve quality and comparability of business information.

⁶ XBRL taxonomies are the dictionaries which the computer languages use. They define the specific tags for individual items of financial data. Due to the differences in accounting regulations, each jurisdiction may have its own taxonomy for financial reporting.

⁷ Including seven posts in the IEC, which is a wholly-owned subsidiary of SFC.

- (a) **Enforcement Division** (12 posts) – to handle an increasing number of investigations, to maintain the day-to-day international enforcement liaison work for the division, to step up existing resources to deal with criminal, civil and disciplinary litigation, and to provide career progression opportunities for graduate trainees and more junior professionals;
- (b) **Intermediaries Supervision Division** (nine posts) – to create one additional inspection team for enhancing efforts to strengthen delivery capability and supervisory framework, to support policy work, to supervise financially risky brokers and review suspected broker fraud cases, and to work on anti-money laundering policy matters;
- (c) **Policy, China & Investment Products Division** (nine posts) – to meet regulatory challenges and increase in workload arising from increase in volume and complexity of applications, expansion of Renminbi product range, increased engagement with the industry, and new development in overseas rules and regulations;
- (d) **Licensing Division** (six posts) – to create a new team for coping with additional workload arising from the creation of the new regulatory regime governing the over-the-counter derivatives market;
- (e) **Centralised Services** (formerly referred to as Chief Executive Officer’s Office) (three posts) – to support activities and interactions with external stakeholders and overseas regulators. This is especially relevant as SFC will assume the chair of the Asia-Pacific Regional Committee of the International Organization of Securities Commissions;
- (f) **Corporate Finance Division** (two posts) – to support the administrative work resulting from the implementation of a statutory disclosure regime for price sensitive information;
- (g) **Supervision of Markets Division** (two posts) – to support efforts to address the various developments (e.g. proliferation of dark pools, and market reform initiatives by the Hong Kong Exchanges and Clearing Limited, etc.) which may impact upon the structure of the Hong Kong market;
- (h) **Legal Services Division** (two posts) – to cope with the increasing civil litigation workload; and
- (i) **Corporate Affairs Division** (two posts) – to meet increase in translation and other administrative workload.

9. SFC has remarked that following the creation of a new regulatory regime governing the over-the-counter derivatives market, the requests for the new over-the-counter licences may be in excess of 1 000 applications. Should that be the case, there will be a need for additional headcounts later in 2013-14.

Reserves

10. SFC estimates that by 31 March 2013, the reserves will reach \$7,237.60 million, which is 5.6 times of the projected expenditure of 2012-13 (\$1,291.71 million).

11. According to section 396 of SFO, SFC may, after consultation with FS, recommend to the Chief Executive-in-Council that the rate or amount of levy be reduced if the reserves of SFC are more than twice its operating expenses for that financial year. SFC effected a levy reduction of 20% in December 2006 and a further 25% in October 2010. SFC offered a licensing annual fee holiday for one year effective on 1 April 2009; and for two years effective on 1 April 2012.

12. At the FA Panel meeting on 6 February 2012 during which SFC's 2012-13 budget was discussed, the Panel asked SFC to conduct a comprehensive review of the use of its reserves and the possibility of a levy adjustment and revert to the Panel in the context of the 2013-14 budget. SFC's considerations and recommendations are set out in paragraphs 13 to 17 below.

Considerations

13. SFC's reserves provide a cushion in times of stress to enable SFC to operate without resorting to Government funding. The level of SFC's reserves depends on the performance of the securities market and the level of expenditure required to meet their operating needs as well as discretionary funding to external organisations. The large reserves currently resulted from sharply increased turnover from 2003-04 and the exceptionally low rent of the Chater House office negotiated and agreed in 2003.

14. As reported by SFC, there has been a significant change in market sentiment, with a bull run culminating in a sharp spike in turnover and reserve levels followed by an extended bust and relatively anaemic turnover. There remains a very high level of uncertainty about financial markets and an intensification of regulatory efforts globally in response to the financial crisis. The rental costs of SFC have increased substantially following the lease of the new office premises at Cheung Kong Center.

15. SFC anticipates that depressed turnover and a significantly higher expense base are likely to result in an operating deficit for the next few years. The period of projected annual operating expenditure covered by reserves will decrease. The reserves accumulated will perform their primary function of enabling SFC to operate effectively in a difficult environment with confidence and without resorting to the taxpayers' money.

16. The existing levy rate of 0.003% represents around 0.8% of total securities trading costs and SFC is of the view that any further reduction will have limited benefits for investors.

Recommendations

17. Having regard to the considerations set out above, SFC does not propose a reduction of the levy rate in 2013-14. SFC also does not propose to earmark reserves for other purposes save to support external organisations whose functions and objectives are aligned with those of SFC. In this regard, SFC is prepared to fund projects that promote the knowledge and education of market participants (also see paragraph 25 below). SFC also remarks that they will remain flexible on the level of licence fees and other direct charges which have a far greater individual impact on licensed corporations and other market participants. SFC is mindful of its obligation under section 396⁸ of SFO and will conduct a detailed review of reserves and levy annually, taking into consideration prevailing market conditions, the expected resources requirements and medium-term financial projections.

Capital Expenditure

18. The total capital expenditure proposed for 2013-14 is \$62.25 million, which is a decrease of \$76.39 million (55.1%) from the revised estimates for 2012-13 (\$138.64 million). This is the combined effect of the completion of the office relocation to the Cheung Kong Center premises in 2012-13 and a projected increase in systems development costs in 2013-14. Provisions for major capital items include the following and a 10% contingency –

/(a)

⁸ Section 396 of SFO provides that –

- (1) If during a financial year of the Commission -
 - (a) the reserves of the Commission, after deducting depreciation and all provisions, are more than twice its estimated operating expenses for the financial year; and
 - (b) the Commission has no outstanding borrowings,the Commission shall consult the Financial Secretary with a view to recommending to the Chief Executive in Council that the rate or amount of a levy be reduced under section 394.
- (2) The Commission may, after consultation with the Financial Secretary under subsection (1), recommend to the Chief Executive in Council that the rate or amount of a levy be reduced under section 394.

- (a) provision for “front-end” technology to upgrade market surveillance capabilities, improve access to and exchange of information between stakeholders and SFC and enhance various IT systems including licensing system, investigation management system and market surveillance system (\$29.50 million);
- (b) provision for replacement of obsolete office equipment due to normal wear and tear and for 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 (\$17.09 million); and
- (c) provision for office furniture and fixtures for reconfiguration of the Cheung Kong Center office, and replacement of obsolete furniture due to normal wear and tear (\$10.00 million).

COMPARISON OF THE ORIGINAL WITH THE REVISED ESTIMATES FOR 2012-13

Income

19. The revised income for 2012-13 is \$1,059.59 million, representing a 29.4% decrease from the original estimate of \$1,500.16 million. This is due to lower-than-expected market activities⁹, resulting in a deficit of \$232.13 million for the year, against a surplus of \$145.12 million in the original budget.

Expenditure

20. The revised expenditure for 2012-13 is \$1,291.71 million, which is \$63.34 million (4.7%) below the original estimate (\$1,355.05 million). The decrease is mainly due to time lag in filling vacancies, lower-than-expected spending to IEC as it came into operation only in November 2012, and savings in legal fees arising from legal costs recovered and the deferral/cancellation of certain external consultancy projects.

Capital Expenditure

21. The revised capital expenditure is \$138.64 million, which is \$11.39 million (7.6%) below the original estimate (\$150.03 million). The under-spending is due to lower expenditure under contingency.

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⁹ The revised estimates for 2012-13 are projected based on the prevailing market performance when SFC devised its budget in December 2012 and the assumption that the average daily turnover of securities transactions is \$50 billion for the remainder of 2012-13. The original estimates are \$77 billion/day.

PUBLIC CONSULTATION

22. The Administration and SFC briefed FA Panel on SFC's 2013-14 budget on 4 February 2013. Members discussed the manpower resources, the levy rate and the reserve level. A motion was passed at the meeting, demanding SFC to lower its levies. SFC has examined FA Panel's concerns and its response to the motion is at Enclosure 2.

Encl. 2

23. SFC has committed to conducting a further comprehensive review of its financial position towards the end of the year, including whether to extend the two-year annual licence fee suspension and whether the levy should be reduced.

ADMINISTRATION'S VIEWS

24. The Administration has examined the budget of SFC for 2013-14. SFC has projected a deficit in its budget, and as in the past years, it has not requested appropriation from LegCo. We note that SFC has taken into account FA Panel's views and proposed various initiatives to address FA Panel's concerns. We also note that SFC has committed to conducting another comprehensive review on the use of its reserves and on the possibility of extending the annual licence fee suspension and levy reduction in the coming year. With regard to the headcount issue and a possible interim request by SFC, the Administration has asked SFC to exhaust all possible options in meeting its additional resource requirements, such as streamlining workflow, redeployment of existing resources and reviewing the vacant headcounts.

25. Specifically, the Administration has invited SFC to consider offering financial support for (a) the curriculum development of suitable training courses in asset management by the market, and (b) continued professional training for the small and medium-sized securities brokers. We have received a positive response from SFC and noted that SFC has already initiated discussions with the Hong Kong Securities and Investment Institute on implementation of these initiatives. We shall keep in view the progress.



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

Enclosure 1 to FCRI(2013-14)5

Securities and Futures Commission
Budget of Income and Expenditure
for the financial year 2013/2014

14 December 2012

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1. Executive summary

- 1.1 Set out below is a summary of the SFC's forecast for 2012/13 and proposed budget for 2013/14. This summary is intended to give an overview of our proposed budget. For more detailed explanations, reference should be made to sections 4 and 5 of this budget book.

	2013/14	2012/13	Variance	
	Proposed Budget (a) HK\$m	Forecast (b) HK\$m	Proposed Budget vs. Forecast (c) = (a-b) HK\$m	(c/b) %
Income	1,065.88	1,059.59	6.29	0.6%
Recurrent expenditure				
Staff cost	955.23	797.47	157.76	19.8%
Premises expenses	220.10	225.75	(5.65)	(2.5%)
Other recurrent expenses	264.76	219.97	44.79	20.4%
Total recurrent expenditure	1,440.09	1,243.19	196.90	15.8%
Funding to external parties	60.95	48.52	12.43	25.6%
Total expenditure	1,501.04	1,291.71	209.33	16.2%
Deficit for the year	435.16	232.12	203.04	87.5%

- 1.2 For 2013/14 we project that income will increase slightly by \$6.29 million (0.6%) over the 2012/13 Forecast. Higher assumed securities market turnover and investment income is partially offset by lower fees and charges.
- 1.3 Expenditure for 2013/14 is expected to increase by \$209.33 million (16.2%) over the 2012/13 Forecast. The increase is mainly attributable to increases in staff costs (\$157.76 million), other recurrent expenses (\$44.79 million) and funding to external parties (\$12.43 million).
- 1.4 As set out in Section 2, the SFC's budget for 2013/14 is premised on the need to ensure that the SFC is adequately resourced to effectively and efficiently carry out its responsibilities amid an increasingly demanding local and global regulatory environment.
- 1.5 Having critically reviewed the manpower needs of the SFC's operating divisions and departments for 2013/14, a net increase of 47 full time positions (6.4%) over the Commission approved headcount has been included in the budget. 9 of these positions are reserved for existing graduate trainees (GTs) as completion of three rotations within the first two years of their Graduate Trainee Programmes. The remaining 6 graduate trainees will be placed into existing vacancies.
- 1.6 The SFC has attempted, wherever possible, to redeploy spare capacity to deal with new regulatory initiatives. For initiatives that are currently in a consultative or preliminary stage, existing resources will be deployed to the extent possible. Please refer to Section 4 for more detailed information about the SFC's 2013/14 manpower plan.

- 1.7 The relocation of our office at Chater House to Cheung Kong Centre (CKC) will be completed in 1Q 2013. Our 2013/14 premises cost has taken into account the full year effect of our phase II take up of the CKC lease in September 2012. The increase is offset by savings in Chater House office rental. As a result, 2013/14 premises expenses are \$5.65 million (2.5%) lower than the 2012/13 Forecast.
- 1.8 Other recurrent expenses for 2013/14 are expected to increase by \$44.79 million over the 2012/13 Forecast. The increase is mainly due to higher professional and other similar expenses (\$32.40 million) and information and systems services expenses (\$6.32 million).
- 1.9 Increase in funding to external parties is mainly attributable to the full year effect of our funding for the Investor Education Centre (IEC) which started operations in Q4 2012.
- 1.10 A deficit of approximately \$435.16 million is expected in 2013/14 leaving our overall reserves at \$6.8 billion at the end of that financial year, approximately 4.5 times our annual costs after depreciation and funding to various external parties.
- 1.11 We have carefully considered the issue of whether we should reduce the levy in light of the level of our reserves. We are likely to run an operating deficit for the next few years. Our accumulated reserves will enable the SFC to operate effectively without resorting to Government funding despite the fact that we may incur accumulated operating deficits. We therefore do not propose a levy reduction in 2013/14. We will however review our reserves and the levy annually, taking into consideration prevailing market conditions, our expected resource requirements and medium term financial projections. Noting the obligation to consult in section 396 of the SFO, we will also include recommendations to the Financial Secretary in each future budget. An information paper containing a more detailed review of the SFC's reserves and levy is attached as Appendix 1.

2. Approach and overview

2.1 Each year the budget is prepared based on a policy of tightly controlling all expenditures, as befits a publicly funded organization. Prior year expenditure levels are used as a benchmark except in areas where additional resources have clearly been identified as necessary to meet our regulatory obligations and objectives or to support new initiatives and regulatory development. Strict controls are applied to ensure that costs stay within budget commitments.

2.2 The SFC's 2013/14 Budget is shaped by three key drivers: strengthening regulatory vigilance, global and domestic regulatory reforms, and facilitating market development.

2.2.1 Strengthening regulatory vigilance

- (a) Uncertainty prevails, and this is holding back investment, job creation and economic growth that are necessary to put major advanced economies back on a more sustainable growth path. The solutions to address the problems are complex and structural. Asia has fared relatively better, but is not immune if the situation in the advanced economies is protracted or worsens. Asia's growth is linked to the economic performance of Mainland China, where growth has recently moderated.
- (b) Against this backdrop, market sentiment has been cautious, as reflected in reduced trading volumes and volatile prices in thin markets. The Hong Kong stock market has seen a significant drop in trading volumes and this affects the revenue and profitability of market participants.
- (c) Whilst Asia has attracted capital flows seeking higher returns and this presents an opportunity, short term capital flows are susceptible to sudden reversals. Investors and other market participants could suffer losses, depending on the severity of any price corrections.
- (d) Effective market monitoring, surveillance and supervision are vital so that prompt action may be taken to ensure orderly and fair markets. As markets become more complex, the SFC must enhance its capabilities to better understand and manage developing risks. In addition to human resources, the SFC must invest in its technology to improve the efficiency of daily operations.
- (e) New market participants, products and platforms will continue to grow on the back of Asia's relative economic prosperity. This has important implication for supervision, authorization and enforcement.

2.2.2 Global and domestic regulatory reforms

- (a) The regulatory landscape has undergone a sea change since the global financial crisis and this will continue. Implementation is now the focus and reaching agreement on this particularly where there are cross-border conflicts on the application of national rules, is a major challenge.

- (b) The reform agenda will continue to occupy regulators as new issues emerge and standards are developed. The SFC has been an active participant in these global reform initiatives through the International Organization of Securities Commission (IOSCO) and the Financial Stability Board (FSB), and must enhance its ability to engage to ensure that Hong Kong's interests are properly represented and protected.
- (c) Adherence to international financial standards is an obligation of FSB membership and a commitment that Hong Kong has made as a member of the FSB. Hong Kong will participate in the Financial Sector Assessment Programme (FSAP) conducted by the IMF and the World Bank once every five years, as well as the peer reviews of the FSB Standing Committee on Standards Implementation.
- (d) The SFC will work with government and other agencies on legislation to implement global reforms such as the regulation of the OTC derivatives market and a new resolution regime.
- (e) In addition, the SFC will implement the new legislation concerning Disclosure of Inside Information and Market Misconduct. Sponsor regulation will also require a major effort to ensure that its goal of protecting the quality of Hong Kong's market is achieved : the regime becomes effective in October 2013.
- (f) These global and domestic agendas require the SFC to take on new or additional responsibilities and the SFC's human resources will need to be strengthened accordingly.

2.2.3 Facilitating market development

- (a) In the pursuit of its regulatory objectives, the SFC must have regard to the competitiveness of Hong Kong as an international financial centre and to facilitate innovation.
- (b) The SFC has been working with authorities in the Mainland to facilitate the integration of Mainland China with global capital markets. This cooperation will continue and intensify as the Mainland internationalises the RMB and gradually opens up cross border investment pathways, from the listed market to asset management.
- (c) Technology will continue to drive financial innovation in products, services and market infrastructure. This requires continual review of the focus and perimeter of regulation to ensure that it remains relevant, consistent and effective.
- (d) HKEx is developing new business opportunities in commodities and derivatives. The SFC will need to spend more time monitoring and supervising these new markets and, generally, a more complex exchange platform, and clearing activities.
- (e) These developments should help create more diverse markets and help Hong Kong be a hub of new business opportunities for the region.

They also present new challenges to maintain the quality and efficiency of markets.

2.3 Summary

2.3.1 In summary, the SFC's budget for 2013/14 is premised on the need to ensure that the SFC is adequately resourced to carry out its day-to-day responsibilities effectively in an increasingly demanding economic and regulatory environment that is facing unprecedented challenges globally.

2.4 We have taken a conservative approach to manpower planning for 2013/14. The 47 new posts requested are driven by a comprehensive assessment of our current workload and future demands. However, it is possible that additional resources may be requested at a later date to manage specific unanticipated projects and initiatives.

2.5 The SFC is committed to enhancing its talent pipeline through the SFC's Graduate Trainee Programme (GTP). The Programme is a three-year structured programme in which all participants move through a two-year rotation of eight month segments followed by a one year placement. The objective is to develop young graduates by giving them exposure to a wide range of the SFC's work before moving into specific roles. We now have a total of 54 graduates who were recruited since the inception of the GTP in 2009, of which ten have been appointed by the SFC in July 2012 as junior professionals. It is important that the SFC continually nurtures and develop a strong, committed and diverse workforce.

2.6 There remains constant demand for legal and compliance talent in the financial services industry. During 2012/13, the SFC has faced a number of challenges in its attempts to recruit more senior external candidates. In most cases, the SFC has found itself in a position where it was unable to match existing remuneration.

2.7 The SFC's pay structure will be re-visited as part of its annual pay benchmarking exercise. We also propose to include a provision of 2% of payroll cost in the 2013/14 budget to mitigate the risk of losing our high performing managers who are critical to provide day-to-day coaching to and leadership of our junior professionals. A failure to proactively mitigate the risk of losing our experienced managers could have a significant impact on operations.

2.8 Recognising that the SFC may not be able to compete with major financial institutions or leading law firms on the basis of pay, the SFC has made progress this year in shaping its employer branding. The SFC's newly-defined employer value proposition highlights the SFC's unique mission and promotes it as the right place for people with a purpose to achieve greater things in their professional life.

2.9 The SFC will also continue to leverage on its comprehensive training programmes, career development opportunities, effective work-life balance, and open communication to attract, engage, and retain the best talent.

3. Assumptions

3.1 Investor levy rates

3.1.1 The levy rates will remain unchanged for the year 2013/14, i.e.

- (a) Investor Levy Rate - Securities, at 0.003%; and
- (b) Investor Levy Rate - Future/Options contracts, at \$0.6/\$0.12 per contract.

3.2 Market turnover

3.2.1 Equity market

- (a) Based on the prevailing market performance, the average securities market turnover is assumed to be \$50 billion/day for the remainder of 2012/13 and \$54 billion/day for 2013/14.

3.2.2 Futures and Options market

- (a) Based on transaction volume for the first six month of 2012/13 (Apr – Sep 12), futures/options market turnover is assumed to be an average of 220,000 contracts per day for the rest of 2012/13. For forecasting purposes we have assumed that volume will increase in line with estimated increase in the securities market turnover. On this basis, futures/options market turnover is assumed to be an average of 238,000 contracts per day in 2013/14.

3.3 Fees and charges

3.3.1 The rates of fees and charges are assumed to remain unchanged for 2013/14.

3.4 Rate of return

3.4.1 The average gross return on investment of our reserve funds before investment management fee is assumed to be 2% p.a. for the year 2013/14.

3.5 Remuneration adjustment

3.5.1 A provision of 5.5% of personnel costs has been included as salary adjustments for staff (see also 5.4.2 (c)). The provision is principally comprised of the forecast market pay movement and merit adjustment.

3.5.2 In arriving at the provision, the Commission has considered a number of factors including but not limited to, macro-economic factors (projected CPI & GDP), the industry remuneration trend for 2013/14 and the labour market conditions for the type of expertise required by the SFC.

3.6 Inflation

3.6.1 Where an estimate of general price level increases is required we have assumed 4% when we do not have specific data and/or quotes on which to estimate our future costs.

3.7 Capital expenditure

3.7.1 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.

4. Manpower plan

4.1 The manpower plan for 2013/14 is based on our assessment of the staff strength required for the effective and efficient discharge of the SFC's regulatory functions and missions for the financial year.

4.2 Interim Headcount – 2012/13

During 2012/13, the Commission approved an interim request of 35 additional posts (30 posts for 2012/13 and 5 posts for Q2 2013) to support work undertaken by the SFC primarily resulting from new and proposed legislation, as well as the SFC's international commitments. These initiatives include:

- a) The statutory regime for the Disclosure of Inside Information;
- b) The institution of direct proceedings by the SFC before the Market Misconduct Tribunal (MMT);
- c) The development of new rules for the regulation of the over-the-counter (OTC) derivatives market in Hong Kong; and
- d) The development of new rules for the sponsor regime for initial public offerings.

4.3 New Headcount Request – 2013/14

Having taken into consideration the approved interim headcount, the SFC has undertaken a comprehensive workload analysis for 2013/14. Consequently, a net increase of 47 full time posts (of which 9 posts are for the placement of graduate trainees) has been included within this budget. The bulk of the additional posts in the budget will be deployed to step up the SFC's core enforcement and supervisory capacity to address the growing volume and complexity of market conduct issues, as well as to proactively deal with the regulatory issues described below.

One of the SFC's priorities for 2013/14 would be to complete its proposals for sponsor regulation.

The SFC is also in the process of laying the foundations for mandatory clearing and reporting of OTC derivatives in Hong Kong and will, in conjunction with the HKMA and the Government, introduce a framework to the Legislative Council in 2013.

Another area of focus centers on comments the SFC received to its electronic trading consultation which raised questions about direct market access, algorithmic trading and internet trading for retail investors. The SFC recognizes that there is a need to establish a clear set of uniform expectations on the orderly and fair operation of these dark pools.

On the international front, as Hong Kong is a major host city to international investors and companies, it is important for the SFC to be involved in shaping the agenda on how the IOSCO will deal with cross-border issues between regulators. Commencing May 2013, the CEO SFC will take up the leadership role as the Chairperson of IOSCO's Asia Pacific Region in order to raise the profile of Asia in international regulatory discussions.

Approximately 66% of the proposed new headcount relate to executive grade positions with the remaining 34% being non-executive grade¹. In 2012/13, the SFC's headcount requests were equally divided between the two broad staff categories. The need for more executive grade staff within the 2013/14 headcount request reflects the SFC's assessment of the increasing complexity of the regulatory environment. Refer to paragraph 4.5 to 4.13 for a detailed analysis of these proposed full time posts.

It should be noted that a critical assessment of areas for potential redeployment of staff and process re-engineering/streamlining has been undertaken.

The unpredictable outlook affecting both economic conditions and financial markets, coupled with the development of legislation dependent initiatives may result in the need for additional resources later in the year.

4.4 Our proposed manpower plan is outlined below:

Division	Headcount			
	Commission Approved 2012/13	Proposed 2013/14	Net Change	Para /ref
Centralised Services ^{Note 1}	23	26	+3	4.5
Corporate Finance	64	66	+2	4.6
Enforcement	160	172	+12	4.7
Intermediaries Supervision	139	148	+9	4.8
Licensing	75	81	+6	4.9
Legal Services	34	36	+2	4.10
Policy, China & Investment Products	103	112	+9	4.11
Supervision of Markets	35	37	+2	4.12
Corporate Affairs	103	105	+2	4.13
TOTAL	736 ^{Note 2}	783	47 ^{Note 3}	

Note 1: Include CEO's Office, Risk and Strategy Unit, International & China Affairs Unit, Secretariat and Press Office.

Note 2: The Commission approved headcount includes the interim headcount request of 35 but excludes 7 posts being transferred from Corporate Affairs (External Relations), SFC to the Investor Education Centre (IEC), which is a wholly-owned subsidiary of the SFC.

Note 3: Including nine posts for the placement of graduate trainees.

4.5 The three new posts in the Centralised Services are comprised of one new headcount each for the Press Office, Commission Secretariat and International & China Affairs Unit. These additional headcount are required to support activities and interactions with the SFC's external stakeholders as well as overseas regulators. This is especially relevant in 2013/14 as the SFC will assume the chair of the Asia-Pacific Regional Committee of IOSCO, commencing May 2013.

4.6 Two non-executive posts are proposed by the Corporate Finance Division (CFD). The first of which is to cater for the placement of one graduate trainee (section 1.5), while

¹ Executive grade refers to positions from Manager grade and above, while non-executive refers to positions below Manager grade

the second position is proposed to support the “Disclosure of Inside Information” team with the administrative work resulting from the new regime.

- 4.7 Four executive posts are proposed by the Enforcement division to lead teams of more junior staff to handle an increasing number of investigations (i.e. the number of open cases have increased by 25% and the number of market misconduct investigations has increased by 18%). The division has seen a growth in larger investigations, which has resulted in an increase in material that needs to be assessed. The size and complexity of these cases have made routine evaluations more resource intensive.

One executive post is proposed to maintain the day-to-day international enforcement liaison work for the division, specifically the division’s ongoing interactions and communications with the China Securities Regulatory Commission (CSRC) and the Mainland which are vital for our Enforcement efforts.

In addition, another executive post is requested to step up existing resources in the Disciplinary team to deal with criminal, civil and disciplinary litigation. The Enforcement Division now has actions against 52 people in 16 cases.

Finally, six executive positions are proposed to provide career progression opportunities for Graduate Trainees and more junior professionals with the division (across the 3 teams).

- 4.8 Intermediaries Supervision Department (ISD) requested a total of nine new headcount. One executive and three non-executives are required to enhance its efforts to strengthen its delivery capability and supervisory framework. Specifically, the additional executive headcount is needed to lead an additional inspection team, which will allow the department to conduct more on-site inspections proportionate to the increase in the number of licensed corporations subject to our supervision regime. Additionally, the teams are expected to face greater complexity, in terms of operating models of licensed corporations and the spectrum of activities conducted (e.g. selling of MPF products).

Furthermore, two additional executive posts are required to support policy work, which includes but is not limited to:

- a) Undertaking international policy work (e.g. FSB, participation in IOSCO analysis group, providing support for IOSCO Asia-Pacific Regional Committee (APRC) work, etc);
- b) Assessing the increasing cross border implications of overseas regulation (e.g. OTC, CRA3, MiFID 2, etc.); and
- c) Supporting interaction with overseas regulators on policies and supervision best practice.

In order to maintain vigilance during a period of economic uncertainty and to safeguard client assets, ISD has requested two additional executive headcount to supervise financially risky brokers and review suspected broker fraud cases (including conducting forensic analyses and inspections).

Finally, ISD has proposed one new executive headcount to work on Anti-money Laundering (AML) policy matters. The Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (AMLO) and AML guidelines will be reviewed with a view to making amendments in 2013. Additionally, ISD will undertake

more intensive preparatory work in 2013/14 for the Financial Action Task Force on Money Laundering (FATF) mutual evaluation, which is expected to occur in late 2014.

- 4.9 Three executive and three non-executive posts are proposed by the Licensing Department (LIC) to create a new team to respond to the additional workload arising out of the creation of the new regulatory regime governing the OTC market. The additional headcount requests are conservative in nature, as it is difficult to precisely gauge the number of licenses that will be issued once the regime comes into operation.

An initial assessment by LIC indicates that the requests for OTC licenses may be substantial (i.e. in excess of 1000 applications); if this assessment proves to be the case, there will be a need for additional headcount requests later in the financial year.

- 4.10 The Legal Services Division (LSD) requested a new executive post to cope with the increasing civil litigation workload. The department is currently handling 142 cases (106 criminal and 36 civil) which represents an increase of 25% over the prior year.

One clerical support headcount is requested to provide assistance to the department, as a result of the expected increase in workload derived from the SFC's direct access to the Market Misconduct Tribunal.

- 4.11 The Policy, China & Investment Product (PCIP) Division requested a total of nine additional headcount, comprising six executive and three non-executive posts, to meet the following regulatory challenges and increase in workload:

- a) Increase in volume and complexity of applications

Market activities on bringing more products for public offering in Hong Kong have been on the uptrend. This is evidenced by the following:

- (i) a total of 108 applications for authorization of unit trusts and mutual funds were submitted during H1 2012/13, representing a 50% increase over the same period in 2011/12. About 30% of these applications from new fund houses seeking to launch their first products in Hong Kong.
- (ii) most ILAS issuers have their resources deployed primarily on producing the product key facts statements and revised offering documents for SFC's authorization during the 12-month SFC Handbook transition period ended in June 2011. With these resources unravelled subsequent to the end of the transition period, ILAS issuers resumed to submit new products for authorization. The number of ILAS applications taken up by the SFC surged by 125% from the 12-month period ended June 2011 to the same period ended June 2012. The SFC has also been urged by the insurance industry as spearheaded by their representative at the LegCo to increase our headcount in view of the volume of ILAS applications.

Apart from the influx of applications, the SFC is also seeing an across-the-board increase in the complexity of products submitted for authorization in response to market developments (e.g. growing volatility, low interest rate) and investors' appetite (e.g. investment exposure to emerging markets). Many of these products use derivatives to achieve their investment objectives thereby exposing investors to additional risks (e.g. counterparty, embedded leverage risks). It is important to ensure there is sufficient senior staff to review the increasing intellectually demanding issues surrounding these complex products.

b) Expansion of RMB product range

The SFC anticipates further increase in volume and broadening of the types of RMB products available to Hong Kong investors.

The CSRC, People's Bank of China (PBOC) and the State Administration of Foreign Exchange (SAFE) announced in April 2012 an expansion of the RQFII scheme quota by RMB50 billion as well as RQFII holders being allowed to develop and launch ETFs tracking A-share indices to be listed on SEHK. Further to the 4 RQFII A-share ETFs authorized and listed in Hong Kong, the SFC expects more to follow suit (as so far 60% of the RMB 50 billion quota remains outstanding/unused).

There have been emerging measures that facilitate expedited development of offshore Renminbi business in Hong Kong, including raising further the RQFII quota, expanding the scope of RQFII holders, and relaxing the investment restrictions of the RQFII scheme. It is also expected that the eligibility requirements for Hong Kong financial institutions to apply for QFII status could be lowered and more QFII quotas will be granted much more rapidly. All of these measures would further expand the scope for RMB product launch, and put additional pressure on the Division's workload.

Processing RMB product applications is resource-consuming given they are a new product category. Furthermore, additional resources will be deployed on the study of new policies and rules as well as discussions with the relevant Mainland authorities on the same.

c) Increased engagement with industry

Soft consultation with the industry is an integral part of most of SFC's regulatory reforms. In the 16 months since the full implementation of the new SFC Handbook in June 2011 up to the end of September 2012, the Division had held at least 19 formal meetings / briefing sessions with the industry on various matters and at least 21 FAQs were issued to provide guidance to the industry. PCIP had also provided responses to over 140 incoming written enquiries during the same period. As such, it is envisaged that more time and resources would have to be spent in engaging the industry players and responding to their enquiries in the future.

d) International regulatory initiatives

New development in the overseas rules and regulations would have impact to the products authorized by the SFC. The implementation of the US FATCA will result in revisions to the offering documents of all SFC-authorized funds which ultimately require the SFC's approval. In addition, the European UCITS V implementation will affect all UCITS funds authorized by the SFC, which accounts for the bulk of SFC-authorized funds.

- 4.12 One executive post is proposed by the Supervision of Markets Division (SoM) to address the various developments (e.g. proliferation of dark pools, HKEx's market reform initiatives including the launch of co-location and new market data services, etc.) which may impact upon the structure of the Hong Kong market. The implementation of regulatory changes in other jurisdictions to address these developments will have implications for the Hong Kong market. The additional headcount will represent an individual with comprehensive market knowledge to assist SoM's work in this area.

One non-executive headcount is required cater for the placement of one graduate trainee (paragraph 1.5).

4.13 One new executive headcount is proposed by the External Relations Department. This is in response to anticipated increase in translation workload in 2013/14 (i.e. due to the increase in the number of policy papers arising from new regulations/consultations and increase in the number of Enforcement cases).

One support headcount is requested by the Finance and Administration Department in order to meet the anticipated increase in administrative workload.

5. Financials

5.1 Income and expenditure statement

Para. Ref.	(a)	(b)	(c)	Proposed		Forecast (b)		
	Budget For Year 2013/14 HK\$'000	Forecast For Year 2012/13 HK\$'000	Approved Budget For Year 2012/13 HK\$'000	Over/(under) Forecast (b)	%	over/(under) Approved Budget (c)	%	
Income								
Investor Levy	5.3.2							
Securities		803,520	744,000	1,145,760	59,520	8.0%	(401,760)	-35.1%
Futures/Options Contracts		70,829	65,783	74,400	5,046	7.7%	(8,617)	-11.6%
Hong Kong Mercantile Exchange		2,336	2,171	-	165	7.6%	2,171	N/A
Fees & Charges	5.3.3	93,700	152,400	167,930	(58,700)	-38.5%	(15,530)	-9.2%
Investment Income	5.3.4	93,000	91,234	106,572	1,766	1.9%	(15,338)	-14.4%
Other Income	5.3.5	2,500	4,000	5,500	(1,500)	-37.5%	(1,500)	-27.3%
Total		1,065,885	1,059,588	1,500,162	6,297	0.6%	(440,574)	-29.4%
Recurrent expenditure								
Premises	5.4.1	220,104	225,752	219,810	(5,648)	-2.5%	5,942	2.7%
Staff cost	5.4.2	955,230	797,474	807,085	157,756	19.8%	(9,611)	-1.2%
Info. & Sys. Services	5.4.3	50,757	44,435	45,408	6,322	14.2%	(973)	-2.1%
General Office & Insurance	5.4.4	9,154	8,523	9,130	631	7.4%	(607)	-6.6%
Training & Development	5.4.5	10,820	9,780	10,500	1,040	10.6%	(720)	-6.9%
Professional & Others	5.4.6	89,805	57,401	75,415	32,404	56.5%	(18,014)	-23.9%
External Relations	5.4.7	21,500	22,963	24,050	(1,463)	-6.4%	(1,087)	-4.5%
Internship Programme	5.4.8	9,720	8,865	10,125	855	9.6%	(1,260)	-12.4%
Contingency	5.4.9	3,000	3,000	6,000	-	0.0%	(3,000)	-50.0%
Depreciation	5.4.10	70,000	65,000	73,000	5,000	7.7%	(8,000)	-11.0%
Total (1)		1,440,090	1,243,193	1,280,523	196,897	15.8%	(37,330)	-2.9%
Funding to external parties								
Funding to FRC	5.5.1	4,863	4,631	4,631	232	5.0%	-	0.0%
Funding to IFRS Foundation	5.5.2	390	390	391	-	0.0%	(1)	-0.3%
Funding to IEC	5.5.3	51,200	29,500	50,500	21,700	73.6%	(21,000)	-41.6%
Funding to FDRC	5.5.4	3,500	14,000	14,000	(10,500)	-75.0%	-	0.0%
Funding for the establishment of the HK XBRL Taxonomy	5.5.5	1,000	-	5,000	1,000	N/A	(5,000)	N/A
Total (2)		60,953	48,521	74,522	12,432	25.6%	(26,001)	-34.9%
Total expenditure (1)+(2)		1,501,043	1,291,714	1,355,045	209,329	16.2%	(63,331)	-4.7%
Result for the year		(435,158)	(232,126)	145,117	(203,032)	87.5%	(377,243)	-259.96%
Reserves brought forward		7,237,595	7,469,721	7,411,867	(232,126)	-3.1%	57,854	0.8%
Reserves carried forward		6,802,437	7,237,595	7,556,984	(435,158)	-6.0%	(319,389)	-4.2%

5.2 Capital expenditure statement

	(a)	(b)	(c)	Proposed		Forecast (b)	
	Proposed	Forecast	Approved	Proposed	Forecast (b)	over/(under)	Approved
<u>Para.</u>	Budget	For Year	Budget	Budget (a)	Over/(under)	Approved	Budget (c)
<u>Ref.</u>	For Year	2012/13	For Year	Forecast (b)			
	HK\$'000	HK\$'000	HK\$'000	HK\$'000	%	HK\$'000	%
Capital expenditure							
	5.6						
Furniture & Fixtures	10,000	83,540	77,140	(73,540)	-88.0%	6,400	8.3%
Office Equipment	17,090	31,667	36,478	(14,577)	-46.0%	(4,811)	-13.2%
Computer Sys. Development	29,500	21,181	22,770	8,319	39.3%	(1,589)	-7.0%
Sub-total	56,590	136,388	136,388	(79,798)	-58.5%	-	0.0%
Contingency	5,659	2,247	13,639	3,412	151.8%	(11,392)	-83.5%
Total	62,249	138,635	150,027	(76,386)	-55.1%	(11,392)	-7.6%

5.3 Income

5.3.1 Annual grant from government

- (a) S.14 of the Securities and Futures Ordinance provides that: “For each financial year of the SFC, the Government shall pay to the SFC out of the general revenue the moneys appropriated by the Legislative Council for that purpose.” As in previous years, the SFC proposes that the Government does not request any appropriation from the Legislative Council for the financial year 2013/14. The SFC’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.

5.3.2 Investor levy

- (a) The following turnover and levy rate assumptions have been used in preparing levy income estimates:

	2012/13			2013/14
	Budget	Apr-Sep (actual)	Oct-Mar (projection)	Apr-Mar (projection)
Securities				
Daily turnover (billion/day)	\$77.0	\$50.0	\$50.0	\$54.0
Levy rate	0.003%	0.003%	0.003%	0.003%
Futures/Options Contracts				
Daily turnover (contracts)	250,000	220,000	220,000	238,000
Levy rate	\$0.6	\$0.6	\$0.6	\$0.6

- (b) The 2012/13 Forecast of Investor Levy – Securities is lower than the Approved Budget by 35.1% (\$401.76 million) whereas Investor levy – Futures and Options is lower than the Approved Budget by 11.6% (\$8.62 million). These variations reflect the differences in market turnover in the first six months of 2012/13 when compared to the estimates underlying the Approved Budget as noted above.
- (c) Based on estimates made by our research team on a basis consistent with prior years, we project the average securities market turnover for 2013/14 will be 8% higher than that of 2012/13.
- (d) We do not propose any reduction in levy rates in 2013/14 having regard to the unstable global market, the uncertainty in local market turnover levels and the necessity to deploy resources to deal with regulatory reform and initiatives after the financial crisis.

5.3.3 Fees and charges

- (a) The Forecast aggregate fees and charges income for 2012/13 is 9.2% (\$15.53 million) lower than the Approved Budget as fees from

Licensing, Investment Products and Corporate Finance are lower than expected.

- (b) The 2013/14 Budget shows a further decrease in fee income of 38.5% (\$58.70 million) against Forecast for 2012/13. This reduction arises mainly from the full year effect of the two-year annual fee holiday granted to existing licensees in 2012/13. Due to the amortisation of licensing fees over the lifetime of the license period, the effect of the fee holiday on recorded income is fully reflected in 2013/14.

5.3.4 Investment income

- (a) Investment income for 2012/13 is forecasted to be \$91.23 million, 14.4% (\$15.34 million) lower than the Approved Budget as we have revised downward the average rate of return from 1.5% to 1.3% p.a., based on the actual return earned during the first six months of the year.
- (b) 2013/14 investment income is budgeted to be \$93 million, \$1.77 million higher than the 2012/13 Forecast. We expect that we will outsource our investment portfolio to external investment managers for management in 2013. Investment management fees is expected to be higher as a result of the outsourcing and change in investment approach from passive “buy-and-hold” to active management. The rate of return depends primarily on the market performance and the ultimate investment strategy adopted.

5.3.5 Other income

- (a) Other income for 2012/13 represents net income generated from FinNet, recoveries from investigation cases and sale of SFC publications.
- (b) Other income for 2013/14 will be \$1.5 million lower than the 2012/13 Forecast as we expect that the operation of FinNet network will cease from April 2013.

5.4 Recurrent expenditure

5.4.1 Premises

- (a) We have exercised our option to end the lease of our office at Chater House in April 2013 in order to save rental expenses. While we are required to pay \$4.5 million to indemnify the landlord for early termination of the lease, the indemnity paid is offset by the \$14.7 million savings in 2013/14 rental expenses.
- (b) Forecast premises expenses for 2012/13 are expected to be higher than the approved budget by \$5.94 million (2.7%) primarily due to payment of indemnity of \$4.5 million for early termination of Chater House lease.

- (c) Expenses for 2013/14 are budgeted to be \$5.65 million (2.5%) lower than 2012/13 Forecast. The drop in expenditure is mainly due to the one-off indemnity for early termination of the CH lease and the office removal costs incurred in 2012/13, which are not repeated in 2013/14.

5.4.2 Staff cost

- (a) The overall staff cost for 2012/13 is forecasted to be lower than the 2012/13 budget by 1.2% (\$9.61 million). This is principally due to the time lag experienced in filling vacancies and a number of positions being under-filled at lower grades.
- (b) The projected headcount at 31 March 2014 is 783², a net increase of 47 (6.4%) over the 2012/13 Commission approved headcount. Please see section 4 for detailed explanations of this increase in headcount. The projected staff cost for 2013/14 is 19.8% (\$157.76 million) higher than the 2012/13 Forecast and 18.4% (\$148.15 million) higher than the 2012/13 budget.
- (c) The 2013/14 budget includes the provision for an average 5.5% pay increase for SFC staff. This is based on preliminary market information from external parties including pay consultants and professional associations (as at November 2012). Detailed proposals for the actual pay increase will be formulated in Q1, 2013.
- (d) A “special pay adjustment” provision of \$14.04 million (2.0% of payroll cost) for high performing staff with retention risk has been made in this budget. Our focus in the coming year is to enhance our ability to retain our high performers (refer to paragraph 2.7).
- (e) The management will determine the specific pay policy and present this to the Remuneration Committee for discussion and to the Commission for approval.

5.4.3 Information and systems services

- (a) The information and systems services expenses forecast for 2012/13 is 2.1% (\$0.97 million) lower than the approved budget due to the lower than expected software maintenance and systems contract services costs.
- (b) For 2013/14, we project a 14.2% (\$6.32 million) increase due to higher software and hardware maintenance costs after the lapse of the warranty period and increases in subscriptions for market data to support enforcement and supervision activities.

² Including nine graduate trainees as set out in paragraph 1.5 above

5.4.4 General office and insurance

- (a) General office and insurance expenses forecast for 2012/13 is 6.6% (\$0.61 million) lower than the approved budget mainly due to savings in office services, printing and stationery expenses.
- (b) Expenses for 2013/14 are expected to be higher than 2012/13 Forecast by 7.4% (\$0.63 million) due to higher printing and stationery and miscellaneous office expenses.

5.4.5 Training and development

- (a) Forecast training related expenses for 2012/13 are 6.9% (\$0.72 million) lower than the approved budget. This is mainly due to savings achieved through effective sourcing of complimentary technical training provided by market practitioners.
- (b) Training and development expenses for 2013/14 are 10.6% (\$1.04 million) higher than forecast due to the projected increase in headcount. Learning and development activities for 2013/14 will evolve to become more competency-based as Competency Models for different operating divisions are being integrated into the staff development agenda.

5.4.6 Professional and others

- (a) Professional and others expenses for 2012/13 are 23.9% (\$18.01 million) below the approved budget mainly due to savings in legal fees arising from legal costs recovered and the deferral/cancellation of certain external consultancy projects.
- (b) Professional and Others expenses for 2013/14 are expected to increase by 56.5% (\$32.40 million) as we do not project any significant recovery of legal costs and the demand for external legal and expert services remains high, especially in the areas of investigation, supervision of intermediaries and authorization of new products.

5.4.7 External relations

- (a) Forecast external relations expenses for 2012/13 are lower than the approved budget by 4.5% (\$1.09 million) due to savings in overseas travelling and publications expenses.
- (b) 2013/14 budget is \$1.46 million (6.4%) lower than the forecast. After the launch of the Investor Education Centre (IEC) in November 2012, expenses in investor education are transferred to the IEC. The \$8.2 million savings in investor education expenses are partially offset by the projected increase in expenses relating to the SFC's international works and regulatory commitments, such as overseas travelling and participating and hosting of international forums in pursuing global and domestic regulatory reforms (refer to paragraph 2.2.2).

5.4.8 Internship programme

- (a) This represents the salary cost of hiring university graduates in support of the Government's internship for university graduates programme and for the SFC to develop a pipeline of leaders for the future. Our proposed expenditure for 2013/14 to recruit and retain these individuals represents an increase of 9.6% over the 2012/13 Forecast.

5.4.9 Contingency

- (a) A contingency of \$3 million is provided for the remainder of 2012/13 and the full year of 2013/14 respectively to cover unforeseen expenses arising from changes in the operating environment or unforeseen special requirements.

5.4.10 Depreciation

- (a) Forecast depreciation expense for 2012/13 is expected to be 11% (\$8 million) lower than budget because of less-than-expected capital expenditure actually incurred in current year.
- (b) Depreciation expenses for 2013/14 will be 7.7% (\$5 million) higher than 2012/13 Forecast as we expect that the "unspent" capital expenditure in 2012/13 will be carried forward and expended in 2013/14.

5.5 Funding to external parties

5.5.1 To continue our support for the work of the Financial Reporting Council, the SFC will provide annual funding of \$4.86 million in 2013/14.

5.5.2 To continue our support for the work of the International Financial Reporting Standards Foundation, the SFC will again provide funding of US\$50,000.

5.5.3 We have reduced our funding to IEC from \$50.50 million to \$29.50 million in 2012/13 to cover the preparatory expenses required for the set-up of the IEC and the operating expenses for the period from 20 Nov 2012 (date of commencement of business) to 31 Mar 2013. In 2013/14, we have provided \$51.20 million for funding the IEC. The funding estimated has not taken into account the rental cost for the space occupied by the IEC at our CKC office (\$0.3 million for 2012/13 and \$3.3 million for 2013/14), assuming that the new office will be ready for their use in March 2013.

5.5.4 The SFC will continue to share 1/4 of the Financial Dispute Resolution Centre's (FDRC) annual operating costs in 2013/14. As the FDRC has accumulated surplus brought forward from the last financial year, it is expected that their funding request will be reduced from the agreed annual funding of \$14 million to \$3.5 million for 2013/14. Nevertheless, the SFC is ready to support the FDRC's operation by providing annual funding up to \$14 million as previously committed in the Memorandum of Understanding in case it is required.

5.5.5 The project on the development of a Hong Kong XBRL³ taxonomy⁴ for financial reporting by Hong Kong listed companies is deferred to 2013/14. To support the development of the project, we have provided \$1 million in our 2013/14 budget.

5.6 Capital expenditure

5.6.1 The total capital expenditure forecast for 2012/13 has been dropped from \$150.03 million to \$138.64 million principally as a result of the reduction of the contingency provision by \$11.39 million.

5.6.2 The total capital expenditure budget for 2013/14 is \$62.25 million, 55.1% (\$76.39 million) lower than 2012/13 Forecast. This is the combined effect of a decrease in renovation and equipments costs for CKC office and a projected increase in systems development costs. The planned capital expenditure commitment for 2013/14 comprises the following:

Capital expenditure	Amount HK\$ m	Note
Office furniture & fixtures	10.00	<i>i</i>
Office equipment	17.09	<i>ii</i>
Computer systems development	29.50	<i>iii</i>
Contingency (10%)	<u>5.66</u>	<i>iv</i>
Total	<u><u>62.25</u></u>	

Notes :-

(i) for office furniture and fixtures:

- \$10 million for Cheung Kong Centre office reconfiguration and replacement of obsolete furniture due to normal wear and tear.

(ii) for office equipment:

- \$1 million for replacement of obsolete office equipment due to normal wear and tear; and
- \$16.09 million for 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.

³ XBRL (Extensible Business Reporting Language) is an open standard that is developed and maintained by XBRL International, a global non-profit consortium of over 650 major companies, organisations and government agencies from 30 countries, including China, UK and the US. It aims at standardizing financial reporting in order to promote transparency and improve quality and comparability of business information.

⁴ XBRL taxonomies are the dictionaries which the computer languages use. They define the specific tags for individual items of financial data. Due to the differences in accounting regulations, each jurisdiction may have its own taxonomy for financial reporting.

- (iii) for “front-end” technology to upgrade our market surveillance capabilities, improve access and exchange of information between stakeholders and the SFC and enhance various IT systems including Licensing system, investigation management system and market surveillance system etc.
- (iv) as in prior year, contingency is set at 10% of the aggregate budgeted capital expenditure.



Review on the SFC’s reserves and levy

Background

1. At the LegCo Financial Affairs Panel meeting held on 6 February 2012 during which the SFC’s 2012/13 budget was discussed, members expressed the view that there is a need for the SFC to reduce the levy rate and lower fees and charges given that our reserves had built up to a level equivalent to more than 5 times our operating expenditure for the year 2012/13.

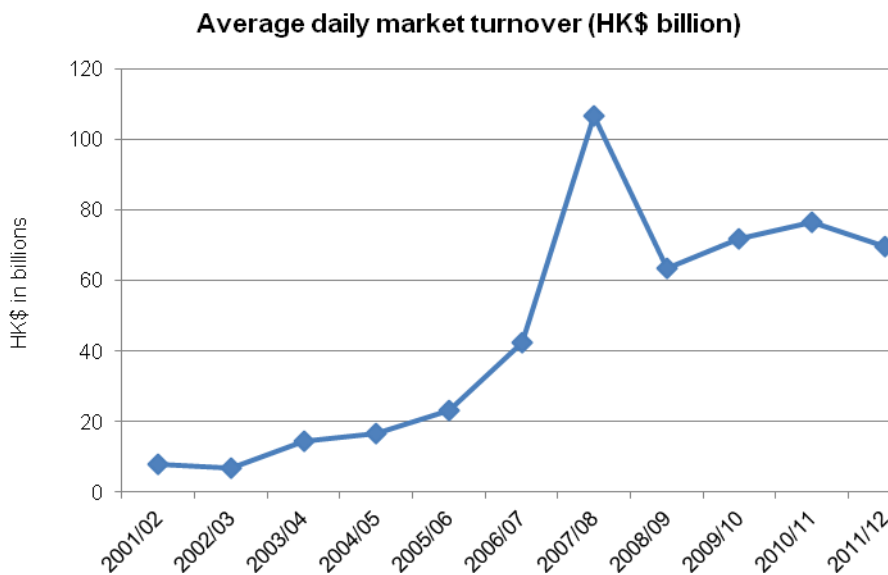
We subsequently implemented a two year annual licence fee “holiday”. Nevertheless, the Panel asked the SFC to conduct a comprehensive review of the use of the SFC’s reserves and the possibility of a levy adjustment and revert to the Panel in the context of the 2013/14 budget.

2. The Commission has done a detailed review of our reserves and levy in August 2012. Our initial findings and recommendations, which were reported to the Financial Secretary in October 2012, are summarised below.

The levy mechanism

3. The SFC’s levy represents approximately 70% of our total income, and is charged to investors at a rate of 0.003% on Stock Exchange dealings. Market turnover is therefore a significant component of our budget.

Diagram 1 – Average daily securities market turnover of the Hong Kong market from 2001 – 2011





4. Under Section 396 of the Securities and Futures Ordinance (SFO), the SFC must consult the Financial Secretary with a view to recommending to the Chief Executive in Council that the rate or amount of the levy be reduced when its reserves are more than twice its estimated operating expenses for the financial year.
5. The levy was reduced from 0.005% to 0.004% in December 2006. In December 2007 we recommended a further 25% levy reduction from June 2008. However, it was agreed to maintain the status quo given uncertainties which were emerging in late 2007. The last rate reduction came into effect on 1 October 2010 when the levy was reduced from 0.004% to 0.003%.

The build-up of the SFC's reserves

6. Our reserves are accumulated from past surpluses. They have grown from \$0.86 billion at the end of 2004/05 (which was equal to 1.9 times the estimated operating expenses for that financial year) to \$7.5 billion at the end of 2011/12 (which was equal to 7.1 times the estimated operating expenses for the financial year). Statistics for levy income, budgeted expenditure, level of reserves and market turnover for the years from 2001/02 through to 2011/12 are set out in the Annex.

The reserves reached their current high level primarily due to two factors – very high market turnover since 2003/04, and exceptionally low rental for Chater House since agreeing the lease in 2003.

Turnover has declined since its peak in 2007/08 of \$107 billion/day; average turnover for the first 5 months of 2012/13 was around \$50 billion/day. The rental cost of our new office at Cheung Kong Center (CKC) is much higher at Chater House. As a result, the SFC's reserves expressed as a multiple of operating expenditure are declining (see Annex). Macro-economic and market conditions are causing a severe and prolonged period of uncertainty, and this is likely to continue to have a negative impact on market turnover.

Utilisation of the SFC's reserves

7. Our reserves enable us to build a buffer to mitigate potential future declines in market turnover and thereby ensure that the SFC has adequate financial resources to deliver its regulatory objectives without resorting to funding from the government. Our reserves can be expected to increase substantially in bull markets, and this accumulated reserve then finances operations during depressed market conditions when our revenue decreases substantially. This is important given the counter cyclical correlation between the need for heightened regulatory activity and the general economic cycle – i.e. stressed market conditions imply greater regulatory intensity and resources.
8. Our reserves are derived from the market and should therefore be used for purposes which contribute to the long term development and integrity of the Hong Kong market. Paragraphs 9 and 10 below discuss these purposes.



9. Meeting operating needs

(a) Increase in staff costs

Responding to regulatory developments

The financial crisis has transformed global regulation which now aims to comprehensively reform banks, markets and financial services.

These developments have far reaching implications. They have increased the responsibilities of regulators and are driving the emergence of global and local regulatory standards which in turn give rise to unprecedented cross-border issues.

There is an increasing need for the SFC to keep informed of and actively contribute to international reforms. The SFC's participation (e.g. via IOSCO) is important to ensure that Hong Kong remains at the forefront of global regulatory change, that outcomes take account of any special characteristics of our markets and so that cross border initiatives can be coordinated properly.

The SFC and other regulators in Hong Kong and globally do not view the increased pace of regulatory reform as a passing trend. This will place increasing demands on regulators, in terms of resources (both human and technological) and associated costs.

In addition, Hong Kong has pursued significant local reforms. Legislative initiatives include but are not restricted to:

- a statutory regime for the Disclosure of Inside Information;
- the institution of direct proceedings by the SFC before the Market Misconduct Tribunal (MMT);
- new rules for the Sponsor regime for initial public offerings to enhance the regulation of sponsors; and
- new rules to enhance the regulation of OTC derivatives.

Development of new functions and capabilities

The markets that we supervise and the financial products we deal with are increasingly complex. This places a significant additional burden on the SFC.

In response, the SFC will be looking to further enhance its existing capabilities as well as develop new functions to better monitor, interact with and regulate the market. These functions will initially draw upon existing expertise from within the SFC, but as they mature, there will be a need to expand capabilities which will ultimately result in a need to increase resources. Recent examples include the establishment of a dedicated International Affairs Unit and a new Risk capability. Others are referred to in the discussion about technology in paragraph 9(c) below. The general point is that there is little doubt that increased regulatory work on a global level, evolving local markets and growing interaction with Mainland China will expand our remit and workload over the next few years.

Anticipated increase in staff cost

Taking the above into account, and to ensure that the SFC is adequately resourced to maintain an effective regulatory and supervisory capability, we conservatively anticipate that our headcount will continue to grow.



(b) **Increase in rental costs**

Rental cost incurred by the SFC correlates to anticipated growth of our headcount as well as the technology infrastructure which supports our analytical, monitoring and supervisory capabilities.

We pay a very low rent in Chater House because we secured advantageous terms in 2003 during SARS. Our premises costs have increased substantially following the commitment to relocate to CKC. The current fully loaded costs of CKC will be 2.4 times of our current rental arrangements at Chater House.

(c) **Enhancement of technology infrastructure and evolving markets**

For the SFC to maintain an effective regulatory regime in Hong Kong, we must invest in our technology, which is an essential regulatory tool. We need to enhance our technology infrastructure in order to (i) effectively analyse and act on the large amount of data reported resulting from new regulations and reforms, (ii) enhance surveillance and the identification of systemic risks and (iii) deal with the evolution of technology-based trading systems and platforms.

Further, global regulation and a changed business environment since the financial crisis is likely to encourage more large multinational financial institutions to reorganise their structures including booking risk locally. Greater cross border RMB business is likely to increase Hong Kong's role as a base for international mainland firms. Both of these developments will require the SFC to enhance its supervisory and enforcement capability.

10. **Funding to external organisations**

Existing commitment

The overarching objective of the SFC is to safeguard the integrity of the Hong Kong market. As part of this, the SFC is committed to the ethos of responsible and informed investing. In the past we have provided financial support to external organisations which have objectives or functions which are aligned with our own, including the following:

- Hong Kong Securities Institute (\$15 million as initial set-up costs in 1997 and an additional \$1.2 million for the development of their curriculum in 2011);
- Financial Reporting Council (\$25 million so far);
- Financial Dispute Resolution Centre (\$21.5 million so far);
- IASC Foundation (\$1.6 million so far); and
- Investor Education Centre (estimated set up and operation costs of approximately \$50 million per annum to be adjusted on inflation).

Provision for future projects

The SFC foresees a growing need to contribute funds to external organisations. Human capital and infrastructure are important for any IFC. We are therefore prepared to fund projects that promote the knowledge and education of market participants and of members of public in the field of financial services and investing. This may include collaboration with tertiary education institutions to develop postgraduate courses in financial services



and financial products or projects that enhance market efficiency such as the development of electronic-data gathering, analysis and retrieval systems. .

11. Based on the current market condition and factors as discussed, we projected that an operating deficit will become the norm from 2012/13 and onwards. Our reserves are therefore expected to decrease unless market turnover increases substantially.

Summary

12. The SFC's reserves provide a cushion in times of stress to enable the SFC to operate without resorting to Government funding. Our ability to accumulate reserves depends on the performance of the securities market and the level of expenditure required to meet our operating needs as well as discretionary funding to external organisations.
13. The large reserves we now have resulted from sharply increased turnover from 2003/04 and the exceptionally low rent at Chater House since 2003.
14. There has now been a significant change in market sentiment: a bull run culminating in a sharp spike in turnover and reserve levels followed by an extended bust and relatively anaemic turnover. There remains a very high level of uncertainty about financial markets and an intensification of regulatory effort globally in response to the financial crisis. Our rental costs are about to rise substantially.
15. Depressed turnover and a significantly higher expense base are likely to result in an operating deficit for the next few years. The period of projected annual operating expenditure covered by our reserves will decrease; the reserves we have accumulated will perform their primary function of enabling the SFC to operate effectively in a difficult environment with confidence and without resorting to the taxpayer.

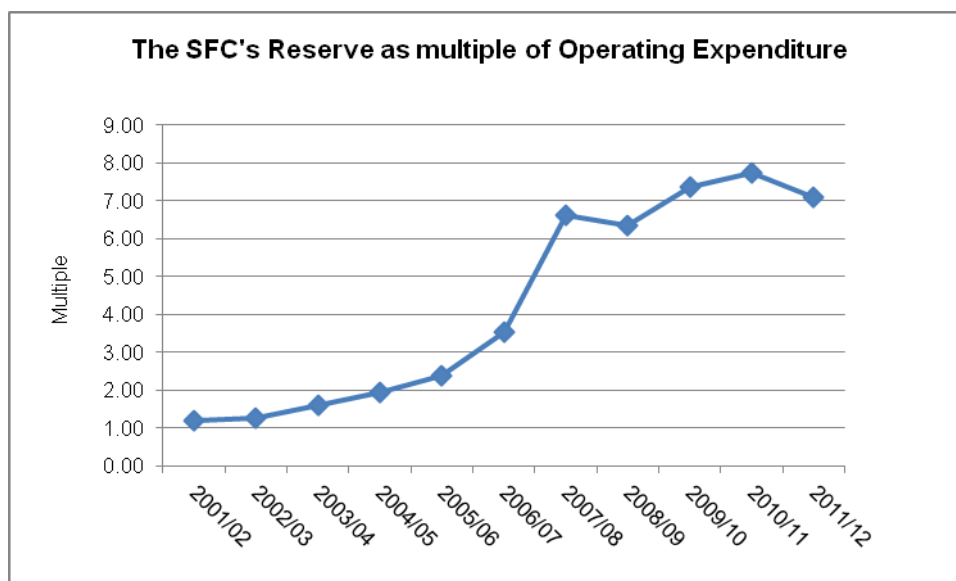
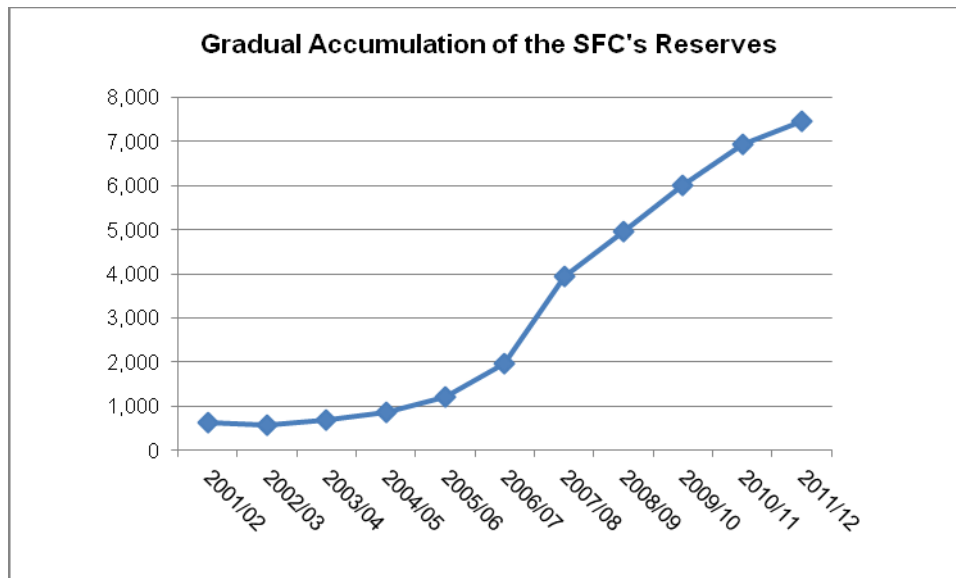
Proposals

16. Any further reduction of the 0.003% levy rate will have limited benefits for investors. It now represents around 0.8% of total trading costs. We project a sustained operating deficit with any funding gap to be made up from our accumulated reserves. We therefore do not propose a reduction at this time.
17. We do not propose to earmark reserves for other purposes save to support external organisations whose functions and objectives are aligned with the SFC.
18. We will conduct a detailed review of our reserves and levy annually, taking into consideration prevailing market conditions, our expected resources requirements and medium term financial projections and, noting the obligation to consult in section 396 of the SFO, will include recommendations to the Financial Secretary in each future budget taking account of the factors and methodologies set out in this paper.



Annex – SFC’s levy income and reserves 2001/02 to 2011/12

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
Average Daily Turnover (HK\$b)	7.80	6.93	14.60	16.76	23.13	42.50	106.80	63.30	71.70	76.70	69.70
Levy Income (HK\$m)	202.62	186.17	380.34	435.44	612.51	1,007.42	2,134.73	1,304.62	1,498.66	1,373.40	1,091.95
Budget Expenditure (HK\$m)	518.35	450.31	433.28	443.40	508.10	561.87	596.76	779.68	816.77	895.34	1,055.18
Year End Reserves (HK\$m)	623.98	565.61	691.02	860.08	1,214.59	1,979.94	3,941.20	4,953.48	6,022.24	6,925.63	7,469.72
Multiple of Operating Expenditure	1.20	1.26	1.59	1.94	2.39	3.52	6.60	6.35	7.37	7.74	7.08





SFC's response to the motion passed at the Financial Affairs Panel (FA Panel) meeting on 4 February 2013 concerning the SFC's levy

1. First, the Commission would like to make clear that it appreciates fully why honourable members have raised this issue. The levy is only a very small part of total stock market trading costs for investors – at a rate of 0.003% it represents approximately 0.8% of total costs, including stamp duty. On the other hand, the Commission's financial reserves are at an historic high. Moreover, the Commission shall consult the Financial Secretary about the rate or amount of levy whenever its reserves exceed twice its operating expenses for a financial year¹, which has been the case since 2005/2006. This means that the Commission, when deliberating its annual budgets, must also consider its overall funding model thoroughly, including the levy. This has resulted in two reductions to date. The Commission conducted an in-depth review when finalizing its budget for 2013/2014 and will do so again during the next budgeting exercise.
2. The following factors were taken into account by the Commission in its last review.-
 - (i) As explained at the FA Panel Meeting held on 4 February 2013, the overriding purpose of the Commission's reserves is to enable it to continue to operate properly whenever turnover is depressed and, as a result, its income does not cover its expenditure. This is counter-cyclical, so that reserves are built up when market activity is high to be used to bridge any funding gap when market activity is low, and ensures that the Commission's work to protect investors and promote confidence in Hong Kong's financial markets is not compromised when there are adverse economic and trading conditions. It also operates to minimize the chances of the Commission needing to rely on government financing – ultimately from taxpayers – to bridge any funding gaps.

¹ Section 396 of SFO provides that –

(1) If during a financial year of the Commission -

(a) the reserves of the Commission, after deducting depreciation and all provisions, are more than twice its estimated operating expenses for the financial year; and

(b) the Commission has no outstanding borrowings,

the Commission shall consult the Financial Secretary with a view to recommending to the Chief Executive in Council that the rate or amount of a levy be reduced under section 394.

(2) The Commission may, after consultation with the Financial Secretary under subsection (1), recommend to the Chief Executive in Council that the rate or amount of a levy be reduced under section 394.



- (ii) The current high level of reserves is largely the result of a very substantial increase in market activity during 2006 to 2008. Stock market turnover fell significantly thereafter reflecting considerable doubt and volatility in financial markets precipitated by the global financial crisis.
 - (iii) When the Commission met to consider its budget for 2013/2014 – and a possible reduction of the levy – there was a high level of uncertainty as to whether it would incur an operating deficit for the current financial year (2012 to 2013) or in future years and, if so, how large any deficit would be. At that time markets had been depressed for some time, with average daily turnover of approximately \$53 billion since the beginning of the financial year in April 2012.
- 3. In light of these factors it was not believed to be the right time to make a decision to reduce the levy again, bearing in mind that it represents the major contributor to the Commission's total income and it was unclear the extent to which our reserves might be needed to help fund a possible persistent operating deficit. However the Commission reaffirmed its support for the suspension of annual licensing fees, recognising that this measure has a greater impact for intermediaries than a reduction of the levy.
- 4. Market conditions have since then remained volatile and unpredictable, but have also shown tentative signs of improvement. During the first part of 2013, daily stock market turnover fluctuated typically between \$60 billion to \$75 billion with some days falling outside this range. The average level of turnover required for the Commission to break even in its next financial year is around \$80 billion per day. We should emphasize here that, as is always the case, the Commission's 2013/2014 budget is based on a conservative approach to manpower planning and other expenditure, and does not take into account the level of our reserves.
- 5. The fact remains that the reserves are large, representing approximately 4.5 times the Commission's budgeted expenses for the 2013/2014 financial year. In light of this, and taking account of the recent increases in stock market turnover, the Commission has recently considered the way forward, although we should make clear that no final decisions have been taken in some areas.
 - (i) First, the Commission will commit to a further comprehensive review of its financial position towards the end of the year. This will include whether to extend the two-year annual licence fee suspension which expires early in 2014. We will also review the levy to decide whether – notwithstanding the fact that it now represents only \$30 per \$1,000,000 of stock market transactions – it should be reduced for a third time in light of prevailing and anticipated market conditions. Clearly, if turnover does



experience a sustained recovery this year and market conditions stabilize, this would be a material factor for the Commission to take into consideration.

- (ii) Second, the Commission believes that its financial position justifies contributions to the community from which the levy is derived – investors and market participants. Some initiatives are described in paragraph (iv) below.
- (iii) Third, additional resources may in any event be required to deal with our operational and policy work, including new derivatives legislation as it is enacted and takes effect, the need to develop regulation for evolving market platforms and infrastructure, the regulatory implications of Hong Kong's emergence as a major asset management center as well as our approach to the future regulation of investment products. We will also be reviewing more broadly how we regulate a range of intermediaries as our licensing and supervision departments merge into a new Division, how we supervise HKEx as it expands into different asset classes and currencies and also how we can more effectively operate under the Securities and Futures Ordinance to more broadly regulate the conduct of listed companies, building on the recently enacted legislation concerning corporate disclosure.
- (iv) In addition, the Commission will also review proposals for more direct financial contributions to help investors and intermediaries. A vital area is investor education, which will continue to be led by the new Investor Education Centre. Another example is the Hong Kong Securities and Investment Institute (HKSI), which sets licensing examinations, and has an important role to play as a provider of training and qualifications for market participants regulated by the SFC. We will be discussing with the HKSI how it can develop further its offering to brokers, asset managers and others operating in the securities markets. The Commission stands ready to support an increased variety and intensity of first class, targeted training to include ethics, technical and markets knowledge and competency as well as compliance and regulation. This would help promote the development of asset management and private wealth management in Hong Kong. We also anticipate that an important focus would be on small and medium sized firms who may not have access to the type of training available in larger institutions but who nevertheless may require tangible assistance to operate effectively, competently and safely in increasingly complex financial markets dependent on sophisticated technology. We recognise that for the HKSI to develop its courses and qualifications could require a substantial level of additional resources.



- (v) The Commission will also look at other ways in which it can contribute meaningfully to initiatives which enhance competence and ethics across the regulated community and also those that are intended to protect investor interests.
6. In short, the Commission (1) will later this year actively re-assess whether improved market conditions may justify a further reduction in our levy and/or other changes to our funding model; (2) is sympathetic to the possibility of an extension of a waiver of our annual licence fees; (3) will always ensure that the SFC's operations are funded properly to effectively and efficiently carry out its important mandate in the interest of all market participants and Hong Kong as an IFC; and (4) will look to take the opportunity presented by the counter-cyclical build-up of our reserves to provide funding for initiatives which have direct benefits for investors and the financial industry as a whole.

Securities and Futures Commission
8 March 2013