立法會
Legislative Council

LC Paper No. CB(1)484/12-13(08)

Ref: CB1/PL/FA

Panel on Financial Affairs
Meeting on 4 February 2013

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

Purpose

This paper sets out background information on the arrangements for funding the operation of the Securities and Futures Commission ("SFC") and the scrutiny of SFC's annual estimates. The paper also summarizes the major concerns and views expressed by members when the budgets of SFC for the four financial years from 2009-10 to 2012-13 were discussed by the Panel on Financial Affairs ("FA Panel") during the Fourth Legislative Council ("LegCo").

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, LegCo enacted the Securities and Futures Ordinance (Cap. 571) ("SFO") which consolidated and modernized ten ordinances including SFCO regulating the securities and futures market. SFO came into operation on 1 April 2003.

3. The regulatory objectives of 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 SFO[1], 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 SFC are mainly overseen by three committees, namely the Budget Committee, Remuneration Committee and Audit Committee.

5. As at 31 March 2012, the actual staff strength of SFC was 611, consisting of 443 professional staff and 168 support staff. The vacancies were 33 and 4 at the professional and support levels respectively[2]. The organizational structure of SFC as at March 2012 is shown in the **Appendix I**.

Financial arrangements

6. Section 14 of SFO provides that the Government shall provide funding to SFC as appropriated by 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 (i.e. budget) for the next financial year[3] to CE for approval. The approval authority was delegated to FS in 1995. 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 four years, the approved budget of SFC was tabled at a Council meeting in

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1 Section 1 of Part 1 of Schedule 2 to SFO

2 Information from Securities and Futures Commission Annual Report 2011-12

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

April or May[4] and the annual report of SFC was tabled at a Council meeting in June or July[5]. It is a practice for SFC and the Administration to brief FA Panel in the month of February or March on SFC budget and other major initiatives proposed for the next financial year.

Major views and concerns expressed by members of the Panel on Financial Affairs

8. The major concerns and views expressed by members when FA Panel discussed the budgets of SFC for the financial years of 2009-10, 2010-11, 2011-12, and 2012-13 at the meetings on 26 February 2009, 1 March 2010, 7 and 28 March 2011, and 2 and 6 March 2012 respectively[6] were summarized in the ensuing paragraphs.

Reserves, levies and fees

9. During the discussion on SFC budgets for the financial years from 2009-10 to 2012-13, members noted that SFC continued to hold huge reserves which far exceeded the two-fold threshold[7] as specified in SFO, and called on SFC and the Administration to consider waiving or reducing the levies and fees charged on market participants. There was also suggestion for SFC to review the deployment of its reserves.

10. Regarding transaction levies[8], SFC advised that there was no absolute requirement that the rates of levy must be adjusted when the reserves had reached the two-fold threshold and changes to levies would be made having regard to the relevant circumstances. SFC had reviewed the levy rates and considered that the reduction was inappropriate in view of the volatile performance of the market. Indeed, SFC had effected a levy reduction of 20% in December 2006 and a further reduction of 25% in October 2010[9]. As for licensing fees[10], SFC advised that the principle of full cost recovery was

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4 SFC approved budgets were tabled at the Council meetings on 13 May 2009, 28 April 2010, 25 May 2011 and 23 May 2012.

5 The SFC annual reports were tabled at the Council meetings on 8 July 2009, 23 June 2010, 8 June 2011 and 27 June 2012.

6 FA Panel held two meetings on 7 and 28 March 2011 to discuss SFC budget for the financial year of 2011-12. The Panel also held two meetings on 2 and 6 March 2012 to discuss SFC budget for the financial year of 2012-13.

7 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 have reached a level more than twice its estimated operating expenses for that financial year.

8 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. The order is subject to the negative vetting procedure of LegCo.

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

10 Under section 395(1)(a) of SFO, the Chief Executive in Council may, after consultation with SFC, make rules to require and provide for the payment of fees to SFC.

adopted. SFC had proposed a one-off waiver of the annual licence fees for over 37,000 intermediaries for one year from 1 April 2009.

11. At the FA Panel meeting on 6 February 2012, members passed a motion expressing great dissatisfaction with SFC budget for 2012-13 and requesting SFC to put forward its budget afresh for consideration by the Panel before submitting it for approval by FS. SFC put forward a revised budget for 2012-13 at the Panel meeting on 2 March 2012, which proposed a two-year waiver of annual licence fees commencing 1 April 2012 and recommended keeping the levy rate unchanged for the year 2012-13. SFC also undertook to re-assess the principles it should apply to the purpose and use of its reserves and any wider implications of this assessment for its funding model. The results of the reassessment would be reflected in SFC's budget for 2013-14.

12. In response to a member's enquiry as to whether SFC would contravene section 396 of SFO if it did not consult FS on the reduction of transaction levies given its reserves were more than twice its annual expenditure, the Administration responded that under section 396 of SFO, SFC had the flexibility to, after consultation with FS, recommend to the Chief Executive in Council as to whether the rate of a levy should be reduced, when its reserves had reached a level more than twice its estimated operating expenses for the financial year. SFC added that the Board of SFC considered that it was not the opportune time to further reduce the levy, as the existing levy rate of 0.003% was already extremely low and the levy rate had been reduced in 2006 and 2010. The Board of SFC would review the deployment of the reserves, including the suitability of using part of the reserves to purchase offices for SFC. The Administration remarked that it would liaise with SFC on this issue. Upon request by the member, the Legal Adviser to FA Panel provided a paper on the issues relating to the levy consultation mechanism under section 396 of SFO, and the restrictions, if any, under SFO on the way the reserves were spent. The relevant paper is hyperlinked in **Appendix II**.

13. There was suggestion from members that SFC should step up its efforts in investor education and publicity given its large reserves. The Administration advised that a cross-sectoral investor education body would be established as a wholly-owned subsidiary of SFC to provide comprehensive investor education programmes to enhance the financial literacy of the public.

<u>Investment of reserve fund</u>

14. During discussion of SFC budgets for 2010-11, 2011-12 and 2012-13, members expressed concern about the relatively low investment return for the reserves, which was assumed to be around 1.5% to 2% in the periods concerned. Members enquired whether SFC would consider ways to enhance the investment returns, such as adopting the investment arrangement of the Exchange Fund.

15. SFC responded that it had a statutory obligation to adopt a very cautious investment strategy for its reserves. SFC had made proposals to the Government regarding the investment strategy of its reserves, and the possibility of outsourcing the investment responsibility to external parties, including appointment of external fund managers to handle the investment of the reserves.

<u>Estimated expenditure</u>

16. During the discussion on SFC budget of 2012-13, members expressed concerns about the significant increase in the expenditure and whether there was adequate oversight in the budget preparation process. Members considered that SFC should exercise stringent control on and attempt to reduce its expenditure in view of the uncertain economic situation ahead.

17. SFC advised that only the expenses and manpower proposals which were fully justified would be included in the proposed budget, which had been worked out based on an assessment of the scope and volume of work of SFC in 2012-13. The proposed budget had been considered by SFC's Executive Committee, the Budget Committee and finally the Board. The Financial Services and the Treasury Bureau ("FSTB") would then be invited to review the proposed budget before it was submitted to FS for approval. The Administration also pointed out that it maintained close liaison with SFC to ensure SFC would exercise prudent control on its expenses, and had impressed upon SFC that the expenditure proposals in the budget should be fully justified.

<u>Staffing issues</u>

Staff remuneration package

18. When FA Panel discussed SFC budgets of 2009-10 and 2010-11, some members questioned the rationale to provide variable pay to SFC senior executives in view of the current economic downturn and the Lehman Brothers Minibonds fiasco. There were views that as SFC staff were performing regulatory duties, they should not be eligible for extra pay for doing their work in a diligent and effective manner.

19. SFC explained that the pay packages of SFC staff comprised an annual fixed pay and a performance related variable pay. In working out the pay packages, SFC had to ensure that the pay offered would be adequate to attract and retain talents required for the discharge of its statutory duties. Splitting the remuneration of SFC staff into the fixed pay and variable pay components was a human resources management tool to drive staff performance, as the variable pay component was performance related. SFC commissioned independent consultants to conduct pay surveys before determining the remuneration levels

and adjustments for the coming year. While SFC would freeze the fixed pay for the directorate staff in 2009-2010, staff would still be eligible for variable pay, the amount of which had yet to be determined but was expected to be lower than that of last year. The performance of staff was assessed by their immediate supervisors based on a five-grade assessment system. The performance of the Chief Executive Officer of SFC was assessed by the Remuneration Committee based on a self-assessment report prepared by officer concerned.

Staff turnover and recruitment

20. During discussion of SFC budget of 2010-11, some members enquired about the need to set aside $2.5 million as a "strategic adjustment" provision to enhance the pay band structure and align salary level of individual staff with the market norm. There were views that SFC should not have difficulty in recruiting staff as it provided greater job security as compared with the private sector. 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 was 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 not involved in regulatory work of the market. As such, 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.

21. During discussion of SFC budget of 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 advised 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 of 94% for the 30 graduate interns recruited in 2009 and 2010 had been satisfactory.

Manpower plan

22. During the discussion of SFC budget of 2012-13, members noted that SFC proposed to create 43 posts. Members enquired whether investigation into cases relating to the Lehman Brothers Minibonds Incident had been completed, whether the staff involved in the investigation work could be re-deployed in order to fill some of the proposed new posts, and whether there

would be additional manpower for processing applications for issue of new investment products to expedite the approval process. SFC advised that it would still have to deal with cases relating to the Lehman Brothers Minibonds Incident. The 43 new posts were required to cope with additional regulatory workload arising from the increasing number of Renminbi products and product complexity, work relating to liaison/co-operation with the Mainland, increase in the number of licensed corporations, increased inspections of sponsors of initial public offerings, investigation and prosecution work relating to the anti-money laundering legislation and increased civil litigation cases, etc. The 12 new posts to be created in the Policy, China & Investment Products Division were mainly for processing applications for issue of new investment products.

Staff secondment/attachment arrangements

23. When FA Panel discussed SFC budgets of 2010-11 and 2011-12, some members opined that arrangements should be made for government officers to be attached to SFC to enhance the officers' experience in market regulatory work. The Administration and SFC advised that a Senior Administrative Officer had been seconded to SFC while two officers from SFC were working in FSTB through an attachment programme. Staff attachment had also been arranged between SFC and its counterparts in the Mainland.

<u>Regulatory and enforcement work</u>

24. When discussing SFC budget of 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, which aimed at seeking settlements between banks and complainants instead of pursuing investigation and enforcement actions on complaint cases. 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. They further stressed the need for SFC to enhance transparency in its operation.

25. On the concern about the top-down approach, 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 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. Regarding the investigation of complaints, SFC advised that it would co-operate with the Police and other regulatory bodies in the

investigation work where appropriate. So far SFC had not received any evidence relating to the Lehman Brothers Minibonds Incident which met the threshold for criminal prosecutions under SFO. On the transparency of the operation of SFC, SFC advised that it 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, SFC's quarterly and annual reports, and daily press releases also provided statistics on the work of SFC, details on its enforcement and prosecution actions. SFC would not disclose the details of cases before completion of investigation.

Office premises

26. During discussion of SFC budgets of 2011-12 and 2012-13, some members suggested that SFC should consider leasing offices in districts with lower office rentals than those in Central and liaise with the Development Bureau with a view to relocating its offices in the building(s) to be developed on the site of the former West Wing of the Central Government Offices. Members also expressed concern about the relocation of the offices of SFC at Li Po Chun Chambers and Chater House to Cheung Kong Center in November 2011 and September 2012 respectively. While members have divergent views on whether SFC, being a regulatory body, should use its reserves to purchase its own offices, they agreed that the offices of SFC should not be luxurious.

27. SFC responded that in order to discharge its functions efficiently, SFC, as the regulatory body for the securities market, should be located in the central financial area. SFC added that it would consider other options as its office location, such as the future re-development at the site of the former Government West Wing offices in Central and sites in the new Kai Tak development area. Purchase of office accommodation was one of SFC's options in using its reserves.

Recent development

28. SFC and the Administration will brief FA Panel at the meeting on 4 February 2013 on SFC's budget for the financial year 2013-14.

Relevant papers

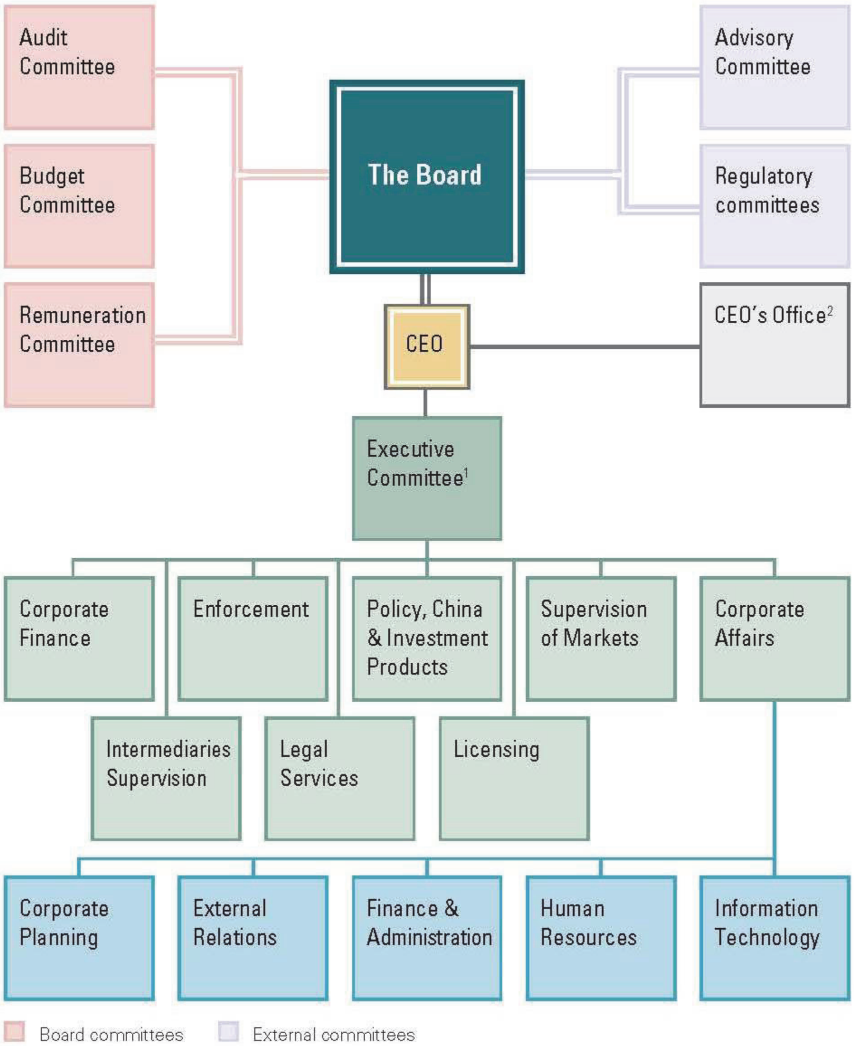
29. A list of relevant papers is in the **Appendix II**.

Council Business Division 1
Legislative Council Secretariat
31 January 2013

Appendix I

Organization structure of the Securities and Futures Commission

Organisation structure



[1] Comprises the Chief Executive Officer (CEO), executive directors, the chief counsel and other senior staff.
[2] CEO's Office includes the functions of Commission Secretariat, risk and strategy and media relations.

Source : SFC Annual Report 2011-12

Appendix II

List of relevant papers

Date	Event	Papers/Minutes of meeting
26 February 2009	FA Panel discussed the proposed budget of SFC for 2009-10	Administration's paper (LC Paper No. CB(1)854/08-09(04)) Minutes (LC Paper No. CB(1)1386/08-09) Follow-up paper by SFC (LC Paper No. CB(1)1173/08-09(04))
1 March 2010	FA Panel discussed the proposed budget of SFC for 2010-11	Administration's paper (LC Paper No. CB(1)1213/09-10(02)) Minutes (LC Paper No. CB(1)1725/09-10)
7 March 2011	FA Panel discussed the proposed budget of SFC for 2011-12	Administration's paper (LC Paper No. CB(1)1458/10-11(03)) Minutes (LC Paper No. CB(1)2037/10-11)
28 March 2011		Minutes (LC Paper No. CB(1)2478/10-11) Follow-up paper by SFC (LC Paper No. CB(1)2060/10-11(01))
6 February 2012	FA Panel discussed the proposed budget of SFC for 2012-13	Administration's paper (LC Paper No. CB(1)959/11-12(03)) Minutes (LC Paper No. CB(1)1417/11-12) Follow-up paper (LC Paper No. CB(1)1147/11-12(04))
2 March 2012		Administration's paper (LC Paper No. CB(1)1147/11-12(04)) Minutes (LC Paper No. CB(1)1871/11-12) Follow-up paper (LC Paper No. LS50/11-12)
27 June 2012	The Annual Report 2011-12 of SFC was tabled at the Council meeting of the Legislative Council	Annual Report 2011-12