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8 March 2013

Clerk to the Panel on Financial Affairs
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong
(Attn: Ms Angel Shek)

Dear Ms Shek,

Panel on Financial Affairs
Follow-up to the meeting on 4 February 2013

Further to the discussion at the Panel on Financial Affairs meeting on 4 February 2013, we attach the bilingual response from the Securities and Futures Commission to the motion as set out in Appendix II to your letter dated 4 February 2013 ***(Appendix)***.

We note that the initiatives described in 5(iv) in the Commission's response would help promote the development of asset management and private wealth management in Hong Kong, which is emphasized by the Financial Secretary in the 2013-14 Budget. We also note that the Commission anticipates that an important focus of the training initiatives would be on assisting small and medium sized firms.

Yours sincerely,

(Miss Sara Tse)
for Secretary for Financial Services
and the Treasury

Encl.

cc: Securities and Futures Commission
(Attn: Mr Paul Yeung)

SFC
證監會

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

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Appendix

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 year[1], 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