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Panel on Financial Affairs
Meeting on 2 February 2015

Updated 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 proposed budgets of SFC for the six financial years from 2009-10 to 2014-15 were discussed by the Panel on Financial Affairs ("FA Panel").

Background

Establishment, regulatory objectives and organizational structure

2. Following the stock market crash of 1987, SFC was established under the then Securities and Futures Commission Ordinance ("SFCO") in 1989 as the statutory regulator of the securities and futures market. In 2002, the Legislative Council ("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. As at 31 March 2014, the actual staff strength of SFC was 753, consisting of 571 professional staff and 182 support staff. The organizational structure of SFC as at March 2014 is shown in **Appendix I**.

Financial arrangements

5. 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 and charges received from market intermediaries since 1993-1994 and thus has not requested for appropriation from LegCo since then.

6. 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[2] 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 six years, the approved budget of SFC was tabled at a Council meeting in April or May[3] and the annual report of SFC was tabled at a Council meeting in June or July[4]. It is a practice for SFC and the Administration to brief FA Panel

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1 Section 1 of Part 1 of Schedule 2 to SFO

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

3 SFC approved budgets were tabled at the Council meetings on 13 May 2009, 28 April 2010, 25 May 2011, 23 May 2012, 22 May 2013 and 28 May 2014.

4 SFC's annual reports were tabled at the Council meetings on 8 July 2009, 23 June 2010, 8 June 2011, 27 June 2012, 26 June 2013 and 25 June 2014.

in the month of February or March of the year on SFC's proposed budget and other major initiatives proposed for the next financial year.

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

7. The major concerns and views expressed by members when FA Panel discussed the proposed budgets of SFC for the financial years of 2009-10, 2010-11, 2011-12, 2012-13, 2013-14 and 2014-15 at the meetings on 26 February 2009, 1 March 2010, 7 and 28 March 2011, 2 February and 6 March 2012, 4 February 2013 and 7 February 2014 respectively[5] were summarized in the ensuing paragraphs.

<u>Reserves, levies and fees</u>

8. During the discussion on SFC's proposed budgets for the financial years from 2009-10 to 2013-14, members noted that SFC continued to hold huge reserves which far exceeded the two-fold threshold[6] 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.

9. Regarding transaction levies[7], 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, after review, considered that a levy reduction 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[8]. As for licensing fees[9], SFC advised that the principle of full cost recovery was adopted. SFC had offered a one-off waiver of the annual licencing fees for one year from 1 April 2009.

10. At the FA Panel meeting on 6 February 2012, members passed a motion expressing great dissatisfaction with SFC's proposed budget for 2012-13 and

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

6 Under section 396(2) of SFO, SFC shall consult FS with a view to recommending to the CE 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.

7 Under section 394(1) of SFO, a levy at the rate specified by the CE 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.

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

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

requesting SFC to put forward its budget afresh for consideration by the Panel before submitting it for FS's approval. SFC put forward a revised proposed budget for 2012-13 at the Panel meeting on 2 March 2012, which included a two-year waiver of annual licencing fees commencing 1 April 2012 and kept the levy rate unchanged. 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.

11. During the discussion of SFC's proposed budget for 2013-14, members passed a motion demanding SFC to lower its levies. Members considered that SFC should not use its waiving of licensing fee on intermediaries as the justification for not considering reduction of the levy rate, as the waiver was a measure catering the licensed intermediaries only; whereas the levy was paid by the investors. There were also views that reduction of SFC's levy rate would lower the investment cost for the ordinary investors and thus enhance the business opportunities for securities firms, especially the small and medium-sized enterprises ("SMEs"). To address members' concern, SFC committed to conducting a further comprehensive review of its financial position towards the end of 2013, and undertook to review proposals for more direct financial contributions to help investors and intermediaries, including the Investor Education Centre and the Hong Kong Securities and Investment Institute.

12. As regards 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 advised that under section 396 of SFO, SFC had the flexibility to, after consultation with FS, recommend to the CE 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. Upon request by a member, the Legal Adviser to FA Panel had provided a paper in March 2012 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. At the FA Panel meeting on 7 February 2014, members noted SFC's proposal in the proposed budget for 2014-15 to reduce the levy rate by 10% (from 1 October 2014)[10] and extend the annual licensing fee holiday for two years starting from 1 April 2014. However, given the uncertainty in local market turnover level and the expected increase in regulatory costs, SFC would continue to incur an operating deficit in future years. To ensure the financial sustainability of SFC, SFC pointed out that the levy rate might need to be

[10] The new levy rates subsequently took effect on 1 November 2014 after the enactment of the Securities and Futures (Levy) (Amendment) Order 2014.

increased if SFC's reserves were depleted to the level of two times the annual operating expenditure.

14. While members welcomed SFC's proposals to reduce the levy rate and extend the annual licensing fee waiver, some members considered that there was room for further reduction of the levy rate as SFC's projection of the average daily securities market turnover was over conservative. These members urged SFC to continue conducting annual review of the levy rate in light of its financial position. As SFC could seek LegCo's approval to increase the levy rate in meeting its operating expenditure when necessary, these members took the view that SFC should not continue to collect levy for maintaining its reserves at three times or above the annual operating expenditure.

Investment of reserve fund

15. During the discussion of SFC's proposed budgets for 2010-11, 2011-12 and 2012-13, members expressed concern about the relatively low investment return for SFC's 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.

16. 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.

17. During the discussion of SFC's proposed budget for 2013-14, in response to members' enquiry about details of the investment income and the management party for SFC's reserves, SFC advised that it had set up an Investment Committee to task with duties including improvement of the investment return. It also pointed out that the investment of SFC's assets was managed by in-house staff in consultation with external investment advisers and that it did not place its surplus with the Exchange Fund for investment by the Hong Kong Monetary Authority.

Staffing issues

Staff remuneration package

18. When FA Panel discussed SFC's proposed budgets for 2009-10 and 2010-11, some members questioned the rationale to provide variable pay to SFC's senior executives in view of the then economic downturn and the Lehman Brothers Minibonds fiasco.

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. 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. In scrutinizing SFC's proposed budget for 2011-12, members expressed concern about the high staff turnover rate of SFC which stood at 25% in 2010 for junior and middle level staff. During the discussion of SFC's proposed budget of 2013-14, members further enquired whether SFC had difficulty in recruiting quality staff, especially in the area of enforcement. Members also expressed concern about whether SFC had sufficient manpower in coping with the increase in caseload and meeting the time pledges for completing investigations.

21. On the high staff turnover rate, SFC pointed out that it had closely monitored the staff turnover situation and reviewed the staff remuneration packages annually as appropriate. As regards difficulty in staff recruitment, SFC admitted that it was difficult to retain and recruit staff, in particular in the areas of legal services, compliance and enforcement, in face of the keen competition for this expertise in the financial services industry, and the more attractive remuneration packages offered by the private sector. The management of SFC had discussed with its pay consultants on the recruitment strategy, with a view to striking a balance of considerations of the market pay level, the unique career rewards for service in SFC, and a sustainable budget. SFC also pointed out that its enforcement team had been facing immense pressure owing to an increase in both the number and complexities of cases to be handled.

Increasing headcounts and professional expenses

22. During the discussion of SFC's proposed budget for 2014-15, members noted with concern SFC's proposal to increase the staff cost by 17.8% (for creating 51 new headcounts), and professional and others expenses by 14.8%. Some members queried whether expenditure increases in the above items were

for driving down SFC's huge reserves. Some other members expressed concern that the substantial increase in SFC's manpower would imply tightening of supervision over intermediaries, thereby increasing the compliance burden on the securities industry, in particular the SMEs which were facing an increasingly difficult operating environment. Members cautioned that SFC should strike a proper balance between enhancing market regulation and development of the financial services industry. It was also suggested that SFC should deploy more resources to strengthen regulation of listed companies and expedite processing of applications for licences and authorizations.

23. SFC stressed that it had exercised prudence in the deployment of its reserves, and its budget was subject to monitoring by the public and LegCo. The proposed manpower increase in the 2014-15 budgets was to deal with specific projects or challenges ahead, including enhancing efficiency of SFC's enforcement process and the supervision of the Hong Kong Stock Exchange, as well as playing a more active role in the regulation of listed companies. SFC assured members that the same regulatory approach was adopted for all licensed corporations, irrespective of their sizes and having regard to their potential risks to the markets. SFC understood that introducing new rules or requirements would inevitably increase compliance costs on the industry but in practice there should be no conflict between investor protection measures and market development. SFC would also consult the industry before introducing new regulatory requirements.

24. As regards the increase in professional and others expenses in the proposed budget for 2014-15, SFC explained that the increase mainly arose from external professional fees and legal fees. Substantial increase in the volume and complexity of SFC's work had put a high demand for external professional services, in particular special expertise for carrying out regulatory functions, such as instructing external counsels in legal proceedings, accountants in investigations, or consultants to advise on systems technology.

Regulatory and enforcement work

25. When FA Panel discussed SFC's proposed budget for 2013-14, there was a suggestion from members that SFC should balance the interests of SMEs and large securities firms when formulating regulatory rules and guidelines for intermediaries. Some members expressed concern about the fairness of the Securities and Futures (Financial Resources) Rules ("FRRs") given that they applied the same requirement to all firms regardless of their sizes. SFC was urged to conduct review of the FRRs for SME brokers having regard to their business viability.

26. SFC responded that it was SFC's principle to exercise fairness in regulation that would be conducive to creating a level playing field for all intermediaries. SFC advised that it was in the process of merging the

Intermediaries Supervision Department and Licensing Department, and the Executive Director of the merged unit would be in charge of a comprehensive review of the regulatory requirements for intermediaries, including FRRs.

27. During the discussion of SFC's proposed budget for 2014-15, some members expressed concern about unclear division of work between SFC and the Hong Kong Exchanges and Clearing Limited ("HKEx") in the regulation of listed companies giving rise to regulatory overlaps or gaps. SFC explained that the regulatory functions of HKEx over listed companies were related to enforcement of the Listing Rules, whereas SFC regulated the securities and futures markets at large, including listed companies, in accordance with SFO. The different perspectives in exercising regulatory oversight as well as the ongoing coordination between SFC and HKEx would help ensure no regulatory overlaps/gaps between the two parties. SFC subsequently provided a paper explaining the division of work between SFC and HKEx in detail which is hyperlinked in **Appendix II**.

Training initiatives

28. During the discussion of SFC's proposed budget for 2014-15, some members noted that SFC had set aside $20 million for funding training initiatives. There was a suggestion from members that SFC should target the resources at assisting SMEs to enhance their competitiveness in facing challenges arising from global regulatory reforms and financial product innovations, and enabling them to seize business opportunities amidst rapid expansion in the financial services sector.

29. SFC explained that the funding would be used mainly for providing training to enhance intermediaries' understanding of new financial products and the latest regulatory requirements. As large financial institutions normally had the resources for organizing in-house training for their market practitioners, it was envisaged that the proposed training would mainly benefit SMEs.

Office premises

30. During the discussion of SFC's proposed budgets for 2011-12, 2012-13 and 2013-14, 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 ("CKC") in November 2011 and September 2012 respectively. While members had 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. Members noted that, in examining SFC's proposed

budget for 2014-15, the Administration had proposed to SFC to consider setting aside part of its reserves for acquisition of office premises as a long-term measure to enhance stability and certainty in the delivery of its services through economic cycles.

31. 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. While the purchase of office accommodation was one of its options in using the reserves, SFC pointed out that it did not intend to acquire office property for investment purpose. During the discussion of SFC's proposed budget for 2013-14, SFC advised that it had decided not to acquire an office property of its own for the time being, given that the lease of the current SFC office at CKC would last for at least five years.

Recent development

32. SFC and the Administration will brief FA Panel at the meeting on 2 February 2015 on SFC's proposed budget for the financial year 2015-16.

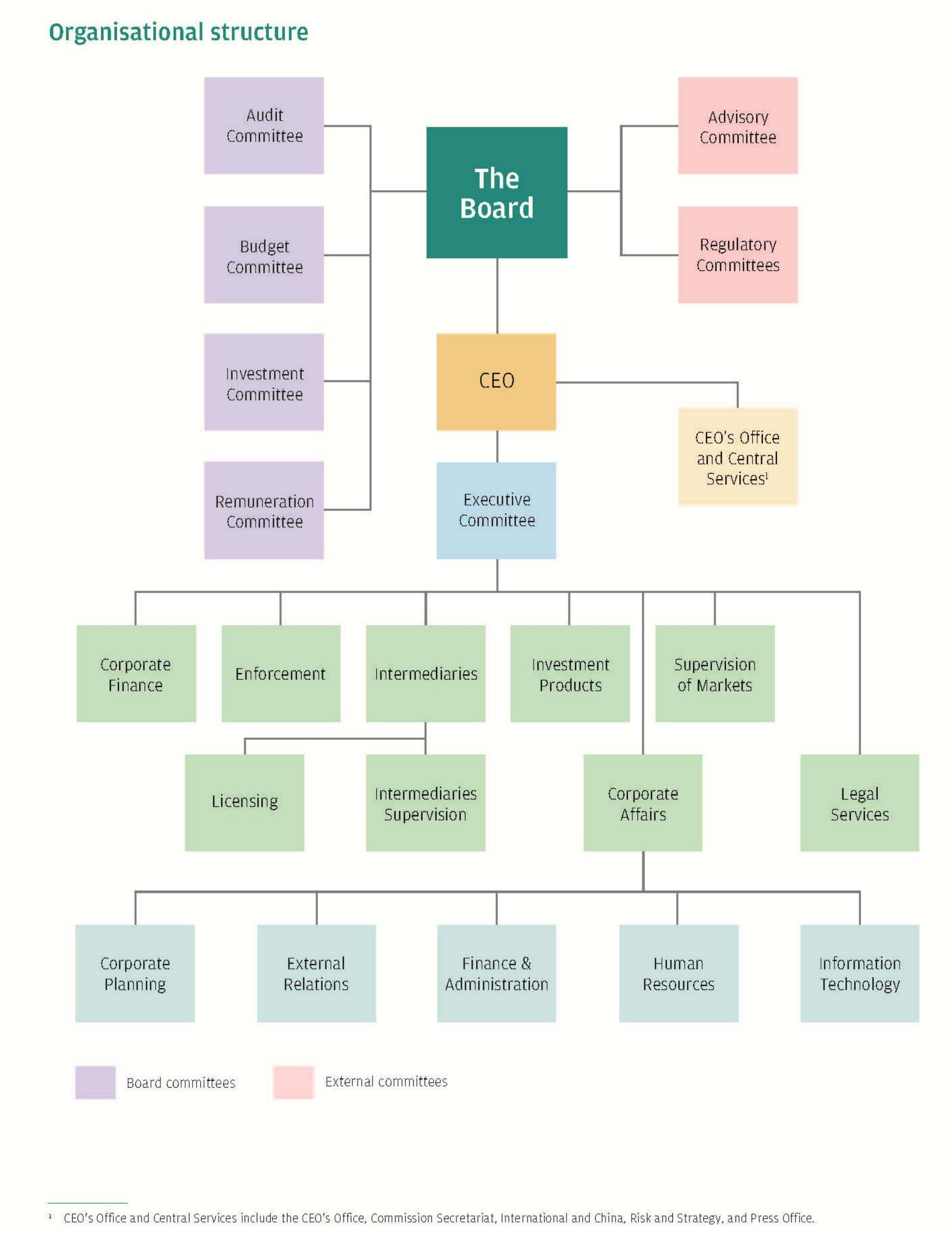
Relevant papers

33. A list of relevant papers is in **Appendix II**.

Council Business Division 1
<u>Legislative Council Secretariat</u>
28 January 2015

Appendix I

Organization structure of the Securities and Futures Commission



Source: SFC's Annual Report 2013-14

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)

Date	Event	Papers/Minutes of meeting
4 February 2013	FA Panel discussed the proposed budget of SFC for 2013-14	Administration's paper (LC Paper No. CB(1)484/12-13(07)) Minutes (LC Paper No. CB(1)930/12-13) Follow-up paper (LC Paper No. CB(1)684/12-13(02))
23 October 2013	The Legislative Council passed the motion on "Reviewing the functions of the Securities and Futures Commission"	Hansard Wording of the motion passed Progress report
7 February 2014	FA Panel discussed the proposed budget of SFC for 2014-15	Administration's paper (LC Paper No. CB(1)804/13-14(04)) Minutes (LC Paper No. CB(1)1658/13-14) Follow-up paper (LC Paper No. CB(1)1039/13-14(02))
25 June 2014	The Annual Report 2013-14 of SFC was tabled at the meeting of the Legislative Council	Annual Report 2013-14