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Panel on Financial Affairs
Meeting on 1 February 2016

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 SFC's proposed budgets for the five financial years from 2011-2012 to 2015-2016 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 10 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 financial services including 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, the Board of Directors of SFC shall make up of no fewer than eight members and the majority of them must be non-executive directors¹. 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 2015, the actual staff strength of SFC was 793², consisting of 608 professional staff and 185 support staff. The organizational structure of SFC as at March 2015 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 from investors and fees and charges from market intermediaries since 1993-94, 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 year³ 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 each of the past five years, the approved budget and annual report of SFC were respectively tabled at a Council meeting in May and June⁴. It is a practice for

¹ Section 1 of Part 1 of Schedule 2 to SFO provides for the composition of the Board of Directors.

² The budgeted headcount in the 2014-2015 budget of SFC was 852.

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

⁴ SFC's approved budgets were tabled at the Council meetings on 25 May 2011, 23 May 2012, 22 May 2013, 28 May 2014 and 27 May 2015. SFC's annual reports were tabled at the Council meetings on 8 June 2011, 27 June 2012, 26 June 2013, 25 June 2014 and 17 June 2015.

SFC and the Administration to brief FA Panel in the month of February or March of each year on SFC's proposed budget and major initiatives proposed for the next financial year.

7. According to section 396 of SFO, if SFC's reserves, after deducting depreciation and all provisions are more than twice its estimated operating expenses for a financial year ("reserves threshold") and SFC has no outstanding borrowings, SFC may consult FS with a view to recommending to CE in Council that the rate of a levy be reduced under section 394 of SFO⁵.

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

8. The major views and concerns expressed by members when FA Panel discussed the proposed budgets of SFC for the financial years from 2011-2012 to 2015-2016 at the meetings on 7 and 28 March 2011, 6 February and 2 March 2012, 4 February 2013, 7 February 2014 and 2 February 2015⁶ are summarized in the ensuing paragraphs.

Reserves, levies and licensing fees

9. During the discussions on SFC's proposed budgets for the financial years from 2011-2012 to 2013-2014, members noted that SFC continuously hold huge reserves which far exceeded the reserves threshold as specified in section 396 of SFO, and called on SFC to consider waiving or reducing the levies and fees charged on market participants. There was also a suggestion for SFC to review the deployment of its reserves.

10. Regarding transaction levies, SFC advised that there was no absolute requirement that the levy rates must be adjusted when the reserves had exceeded the reserves threshold, and changes to the rates would be made having regard to the relevant circumstances. SFC had effected a levy reduction of 20% in December 2006 and a further reduction of 25% in October 2010⁷. As for licensing fees⁸, SFC advised that the principle of full cost recovery was adopted.

⁵ Under section 394(1) of SFO, a levy at the rate specified by CE in Council by order published in the Gazette shall be payable to SFC by the person so specified by CE in Council for the sale and purchase of securities or futures contracts. The order is subject to the negative vetting procedure of LegCo.

⁶ FA Panel held two meetings on 7 and 28 March 2011 to discuss SFC's proposed budget for the financial year of 2011-2012. The Panel also held two meetings on 6 February and 2 March 2012 to discuss SFC's proposed budget for the financial year of 2012-2013.

⁷ The new levy rates took effect on 1 October 2010 after the enactment of the Securities and Futures (Levy) (Amendment) Order 2010.

⁸ Under section 395(1)(a) of SFO, CE in Council may, after consultation with SFC, make rules to require and provide for the payment of fees to SFC.

It had offered a one-year waiver of the annual licensing fees with effect from 1 April 2009.

11. At the FA Panel meeting on 6 February 2012, members passed a motion expressing great dissatisfaction with SFC's proposed budget for 2012-2013 and requesting SFC to put forward its budget afresh for consideration by the Panel before submitting it for approval of FS. SFC put forward a revised proposed budget for 2012-2013 at the Panel meeting on 2 March 2012, which included a two-year waiver of the annual licensing fees commencing on 1 April 2012 and kept the levy rates unchanged.

12. At the FA Panel meeting on 2 March 2012, members expressed concern whether SFC would contravene section 396 of SFO if it did not consult FS on the reduction of levies given that its reserves had exceeded the reserves threshold. Upon members' request, the Legal Service Division ("LSD") of the LegCo Secretariat 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 spent⁹. LSD considered that the requirement for SFC to consult FS under section 396 of SFO would arise only when SFC had a view to propose a levy reduction.

13. During the discussion of SFC's proposed budget for 2013-2014, members passed a motion demanding SFC to lower its levies. Members were of the view that the licensing fee waiver only benefited licensed intermediaries, and SFC should not use the fee waiver as a justification for not considering a reduction on the levy rates, which were paid by investors. There were also views that a levy reduction would lower the investment cost for 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 funding to the Investor Education Centre ("IEC") and the Hong Kong Securities and Investment Institute.

14. At the FA Panel meeting on 7 February 2014, members noted SFC's proposal in the proposed budget for 2014-2015 to reduce the levy rates by 10%¹⁰ and extend the annual licensing fee holiday for two years starting from 1 April 2014. While members welcomed SFC's proposals, some members considered that there was room for further reduction of the levy rates as SFC's projection of the average daily securities market turnover was over-conservative. They urged SFC to continue conducting annual review of the levy rates, and

⁹ See LC Paper No. LS50/11-12

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

cease the collection of levy when its reserves reached three times of SFC's annual operating expenditure. SFC responded that 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, the levy rates might need to be increased if SFC's reserves were depleted to below the reserves threshold.

15. At the FA Panel meeting on 2 February 2015, in view of the projected deficit of SFC in its proposed budget for 2015-2016, some members suggested that SFC should consider imposing a special levy on the northbound trading under the Shanghai-Hong Kong Stock Connect ("S-HK SC"). SFC advised that a substantial part of its reserves was built up in 2007-2008 because of the extraordinarily large market turnover at that time. Following past reductions in the levy rates, it was expected that SFC would continue to incur annual operating deficit of some \$400 million, unless there was substantial improvement in the market turnover in future, and SFC's reserves was expected to fall below the reserves threshold in five years' time. SFC did not have plans to impose a levy on the northbound trading under S-HK SC at the current stage, and would conduct a comprehensive review of S-HK SC six months after its implementation.

Investment of the reserve fund

16. During the discussions of SFC's proposed budgets for 2011-2012 and 2012-2013, members expressed concern about the relatively low investment return on 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 ("EF"). When FA Panel discussed SFC's proposed budgets for 2013-2014 and 2015-2016, members enquired about details of the investment income and management party for SFC's reserves.

17. SFC responded that it had a statutory obligation to adopt conservative and cautious strategies in investing its reserves, including capping investment in equity funds at 15% of the overall investment portfolio and putting the remaining 85% on fixed-income investments (e.g. bonds). SFC had set up an Investment Committee to task with duties including exploring measures to improve the investment returns on its reserves. The Committee had appointed four fund managers to handle investments of SFC's reserves. The investment of SFC's assets was managed by in-house staff in consultation with external investment advisers. SFC did not place its surplus with EF for investment by the Hong Kong Monetary Authority ("HKMA").

Human resources issues

Staff turnover and recruitment

18. In scrutinizing SFC's proposed budget for 2011-2012, 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 for 2013-2014, members 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 increased caseload and meeting the time pledges for completing investigations.

19. SFC pointed out that it had closely monitored the staff turnover situation and reviewed the staff remuneration packages annually. 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 the recruitment strategy with its pay consultants, with a view to striking a balance between offering attractive remuneration packages and maintaining a sustainable budget, taking into account the market pay levels and the unique career rewards in SFC. SFC also pointed out that its enforcement team had been facing immense pressure owing to an increase in both the number and complexity of cases to be handled.

Special pay adjustment

20. When FA Panel discussed SFC's proposed budget for 2015-2016, members enquired about the rationale for providing a special pay adjustment for high performing and experienced staff, how high performing staff would be identified, and whether the special pay adjustment would be a recurrent measure.

21. SFC explained that the turnover rate of 12% to 13% of SFC's junior professionals was higher than the overall staff turnover rate of 8%. The purpose of the special pay adjustment was to retain high performing and experienced staff, which would help lower the cost for training replacement staff. The special pay adjustment would only be implemented on positions or particular job areas with a relatively higher turnover rate taking into account the salaries offered by the private sector for comparable positions. SFC would identify the high performing staff according to the established staff appraisal mechanism.

Headcounts and professional expenses

22. During the discussions of SFC's proposed budgets for 2014-2015 and 2015-2016, members noted with concern SFC's increasing headcounts and staff cost as well as professional and other expenses. Some members queried whether expenditure increases in the above items were for driving down SFC's huge reserves, and whether SFC had plans to further expand its manpower in the coming years.

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. SFC advised that the approved annual manpower requests from 2011-2012 to 2015-2016 were 61, 88, 58, 58 and 39 respectively, whereas the total headcounts in each of these five financial years were 648, 736, 794, 852 and 891 respectively. SFC considered the substantial headcount increase over these years necessary for proper regulation of the growing securities market, dealing with specific projects or challenges ahead (e.g. enhancing efficiency of SFC's enforcement process and the supervision of the Hong Kong Stock Exchange, and its role in regulating listed companies). SFC expected that the total headcount of 891 in 2015-2016 would be sufficient to cope with the current workload, unless there was further expansion in SFC's regulatory ambit.

24. As regards the increase in professional and others expenses in the proposed budget for 2014-2015, 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, and consultants to advise on systems technology.

Regulatory and enforcement work

Maintaining a level playing field for securities firms

25. When FA Panel discussed SFC's proposed budgets from 2013-2014 to 2015-2016, there were suggestions that SFC should strike a proper balance between market regulation and market development, and maintain a level playing field for securities firms of different sizes. Some 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. There was also concern about the fairness of the Securities and Futures (Financial Resources) Rules ("FRRs") which applied the same requirement to all firms regardless of their sizes. Members urged that SFC should conduct a review of FRRs for SME brokers taking into account their business viability. It was also suggested that SFC should deploy more

resources to strengthen regulation of listed companies and expedite the process of applications for licences and authorizations.

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 the Intermediaries Division (which had merged the Intermediaries Supervision Department and Licensing Department) would be in charge of a comprehensive review of the regulatory requirements for intermediaries, including FRRs.

27. As regards compliance burden on the securities industry, SFC stressed that it had been adopting a fair and just regulatory approach and following international standards and practices at large for all regulated parties, irrespective of their scale of operation and having regard to their potential risks to the market. In fact, SFC attached much importance to ensuring proper regulation of the large financial institutions due to the potentially greater systemic risks such institutions would pose on the market and the investing public. 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 continue to engage the industry when taking forward regulatory initiatives. Moreover, SFC had cut down the time for authorization of funds to six months and the average time taken for processing the applications was below that.

Division of work between the Securities and Futures Commission and the Hong Kong Exchanges and Clearing Limited

28. During the discussion of SFC's proposed budget for 2014-2015, some members expressed concern about the unclear division of work between SFC and the Hong Kong Exchanges and Clearing Limited ("HKEx") in the regulation of listed companies, which might give 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 that there would be no regulatory overlaps/gaps between the two parties. SFC subsequently provided a paper explaining the division of work between SFC and HKEx in detail¹¹.

¹¹ See LC Paper No. CB(1)1039/13-14(02)

Regulation of investment-linked assurance schemes

29. During the discussion of the proposed budget of SFC for 2013-2014, members relayed the concern of the insurance industry about the long time taken by SFC in vetting applications of investment-linked assurance schemes ("ILAS"). Members urged SFC to streamline the procedures and strengthen training for new staff to enhance the efficiency of processing ILAS applications. SFC responded that it had been exchanging views with the Hong Kong Investment Funds Association to enhance the efficiency of processing ILAS applications. The processing time should take into account the complexity of the products in question and the need to ensure sufficient investor protection.

30. When FA Panel discussed SFC's proposed budget for 2015-2016, members enquired about the actions taken by the authorities on complaints relating to ILAS. It was suggested that SFC, the Office of the Commissioner of Insurance ("OCI") and HKMA should enter into a memorandum of understanding ("MOU") clarifying their respective responsibilities and enhancing cooperation in the enforcement actions relating to ILAS. It was also suggested that the regulation of ILAS should be taken up by the future independent Insurance Authority ("IA") having regard to its supervisory role for insurance intermediaries, its expertise in insurance products and the heavy workload of SFC.

31. SFC explained that under the current regulatory structure, point-of-sale bank, broker and agent insurance intermediaries were regulated and supervised by HKMA and OCI, whereas insurance companies issuing ILAS policies were regulated by OCI. ILAS products and their offering documents were authorized by SFC under a disclosure-based regime. SFC, HKMA and OCI had been working closely on ILAS-related issues. Concerted efforts of the three regulators had resulted in the revamped guidelines for new product design, enhanced disclosure requirements for commission payments, and remuneration structures for ILAS products. The three regulators would continue to monitor the market situation after implementation of the enhanced regulatory measures, coordinate among themselves in respect of ILAS matters, and review the effectiveness of the regulatory control on ILAS with the establishment of IA. The Government would continue to facilitate the ILAS product revamp exercise. The future IA could sign an MOU with SFC and HKMA to enhance cooperation in relation to the regulation of ILAS.

Access to confidential information on Mainland-incorporated entities

32. During the briefing on SFC's proposed budget for 2015-2016, members expressed concern about the difficulty for Hong Kong auditors to access confidential information held by Mainland auditors in respect of Mainland-incorporated entities when performing audits for their parent

companies listed in Hong Kong. Members enquired if SFC would consider entering into an MOU with the China Securities Regulatory Commission ("CSRC") to enable Hong Kong auditors, when undertaking audits for Mainland entities, to examine the audit working papers of Mainland auditors engaged by the Mainland entities concerned.

33. SFC responded that it had been holding discussions with CSRC on the matter and both parties were committed to seeking a solution. It was believed that the enhanced bilateral MOU signed between SFC and CSRC in respect of S-HK SC could serve as an initial basis for tackling some of the issues. SFC would continue to take the opportunity of regular visits to CSRC's Chairman to discuss related issues.

Training initiatives and investor education

34. When FA Panel scrutinized SFC's proposed budget for 2014-2015, some members noted that SFC had set aside \$20 million for funding training initiatives and suggested that the resources should target at assisting SMEs in enhancing their competitiveness to meet the challenges arising from global regulatory reforms and financial product innovations, and seizing the business opportunities amidst rapid development in the financial services sector.

35. 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.

36. During the discussions of SFC's proposed budgets for 2013-2014 and 2015-2016, members suggested that SFC should step up its efforts in investor education and publicity given its large reserves. They enquired about SFC's plan to strengthen investor education with the launch of S-HK SC, in particular to enhance awareness of risks associated with trading through the system and differences in the regulatory regimes of Hong Kong and the Mainland.

37. SFC advised that it had set aside \$51.2 million and \$3.5 million in the 2013-2014 budget for IEC and the Financial Dispute Resolution Centre respectively for implementing investor education programmes and assisting financial institutions and their individual customers in resolving monetary disputes through mediation and arbitration. Moreover, IEC had launched investor education programmes in respect of S-HK SC through various channels and implemented related initiatives in collaboration with the Mainland authorities.

Office premises

38. During the discussions of SFC's proposed budgets for 2011-2012, 2012-2013, 2013-2014 and 2015-2016, 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 to the building(s) to be developed on the site of the former West Wing of the Central Government Offices. 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 2014-2015, 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.

39. 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. 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 an office property for investment purpose. SFC also advised that the first exit option for the office accommodation in Cheung Kong Center would be in 2017. SFC would continue to explore different options, including acquisition of premises and/or relocation of all or part of its offices to areas outside Central.

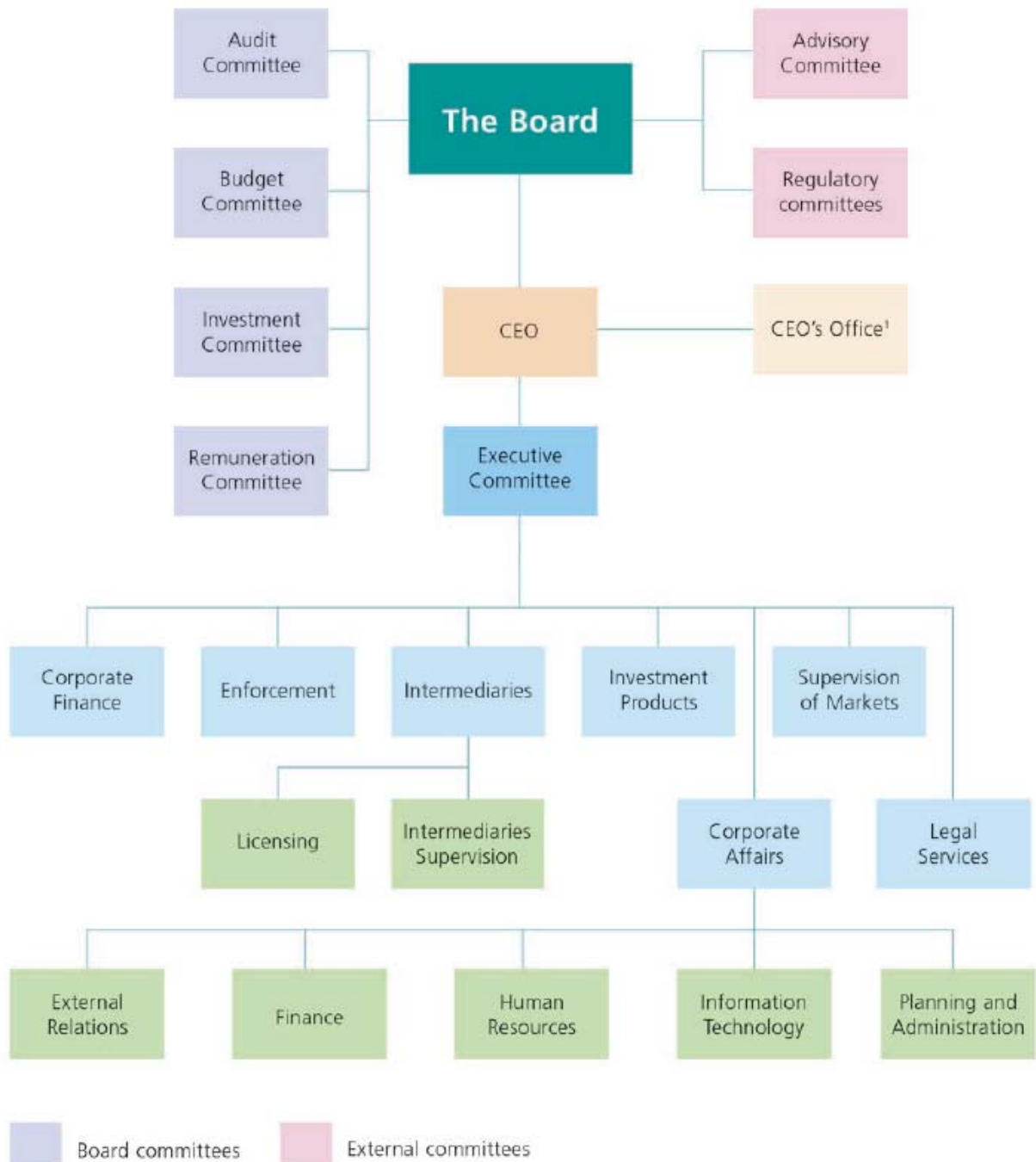
Recent development

40. SFC and the Administration will brief FA Panel at the meeting on 1 February 2016 on SFC's proposed budget for the financial year 2016-2017.

Relevant papers

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

Organization structure of the Securities and Futures Commission



¹ CEO's Office includes the Commission Secretariat, International and China, Risk and Strategy, and Press Office.

Source: SFC's Annual Report 2014-15

List of relevant papers

Date	Event	Papers/Minutes of meeting
7 March 2011	FA Panel discussed the proposed budget of SFC for 2011-2012	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 2012-2013	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)
4 February 2013	FA Panel discussed the proposed budget of SFC for 2013-2014	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

Date	Event	Papers/Minutes of meeting
7 February 2014	FA Panel discussed the proposed budget of SFC for 2014-2015	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))
2 February 2015	FA Panel discussed the proposed budget of SFC for 2015-2016	Administration's paper (LC Paper No. CB(1)445/14-15(05)) Minutes (LC Paper No. CB(1)781/14-15) Follow-up paper (LC Paper No. CB(1)581/14-15(04))
18 March 2015	Hon SIN Chung-kai raised a written question regarding regulation of ILAS	Hansard
10 June 2015	Hon SIN Chung-kai raised an oral question regarding regulation of sale of ILAS products	Hansard
17 June 2015	The Annual Report 2014-2015 of SFC was tabled at the meeting of the Legislative Council	Annual Report 2014-15