

Legislative Council Panel on Financial Affairs

**Securities and Futures Commission
Budget for the Financial Year 2006/07**

PURPOSE

The purpose of this paper is to highlight the main features of the budget of the Securities and Futures Commission (“SFC”) for 2006/07.

BACKGROUND

2. Section 13(2) of the Securities and Futures Ordinance (Cap. 571) (“SFO”) requires the SFC to submit an 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. In accordance with section 13(3) of the SFO, the Financial Secretary shall cause the budget to be laid on the table of the Legislative Council. In line with past practice, the Administration has prepared this paper to invite Members to note the main features of the budget of SFC. A copy of the budget is attached at Annex.

FUNDING OF THE SFC

3. Part XVI of the SFO provides that the SFC may be financed by transaction levies, fees and charges on services rendered to market operators and participants. Section 14 of the SFO further provides that the Government shall provide funding to the SFC as appropriated by the Legislative Council. In practice, the SFC has not requested for appropriation from the Legislative Council since 1993/94, and its funding basically comes from the market in the form of levies, fees and charges.

4. Over the years, income from levies on securities and futures contracts trading has been the most important source of income for the SFC. The current rate of levy on securities transactions is 0.005%. For

futures and options contracts, the current levy is \$1.0 or \$0.2 per leviable transaction, depending on the type of contracts.

5. As regards fees and charges, the SFC adopts, to the extent possible, the principle of full cost recovery. The rates of SFC fees and charges have not been revised since 1994.

BUDGET for 2006/07

6. As at end-October 2005 when the budget was prepared, the reserves of the SFC reached \$1,023.72 million, which is 2.02 times of its approved operating expenditure for the current financial year. The SFC estimated that by 31 March 2006, the reserves will reach \$1,080.92 million¹, which is 2.12 times the operating expenditure of the revised estimates for 2005/06. According to section 396 of the SFO, the SFC shall consult the Financial Secretary with a view to recommending to the Chief Executive in Council that the rate of a levy be reduced if the reserves of SFC are more than twice its estimated operating expenses for that financial year. In the Budget Speech delivered on 22 February 2006, the Financial Secretary announced the proposal to reduce the levy on securities trading and futures and options contracts by 20%. This has been reflected in SFC's budget for 2006/07.

7. The SFC has projected a surplus budget of \$25.30 million for 2006/07. With the projected budget surplus and a reasonable size of reserves, for the fourteenth year in a row, the SFC did not request any appropriation from the Legislative Council for the 2006/07 budget as provided for under section 14 of the SFO². The main features of the 2006/07 budget are set out in paragraphs 8 to 17 below.

(a) Estimated Revenue

8. The estimated revenue for 2006/07 is \$587.17 million, which

¹ The reserves of the SFC has reached \$1,075.39 million as at end-December 2005 according to its unaudited financial statement issued in mid February 2006.

² Part XVI of the SFO provides that the SFC may be financed by transaction levies, fees and charges. Section 14 of the SFO provides that the Government may provide funding to the SFC as appropriated by the Legislative Council. The SFC has not requested for appropriation since 1993/94 although the SFC ran into deficits in 1998/99, 2001/02 and 2002/03.

is 19.59% below the revised estimates for 2005/06, taking into account the following factors –

- (a) levy income from securities and futures and options contracts is projected to decrease by \$158.02 million (31%), assuming –
 - (i) the average daily turnover for 2006/07 is \$16.5 billion, which is 13% below the \$19 billion assumed in the 2005/06 revised estimates; and
 - (ii) the transaction levy for securities will be reduced by 20% from the prevailing rate of 0.005% to 0.004%;
 - (iii) the transaction levy for leviable futures and options contract will also be reduced by 20% from the prevailing rate of \$1 or \$0.2 (depending on the type of contracts) to \$0.8 or \$0.16 respectively; while
- (b) income from fees and charges will be higher than the 2005/06 revised estimates by \$9 million (4.89%) arising from more licensing activities.

(b) Estimated Operating Expenditure

9. The estimated operating expenditure for 2006/07 is \$541.87 million, which is \$56.02 million (11.53%) above the 2005/06 revised estimates (\$485.85 million). The increase is mainly attributable to –

- (a) increase in Personnel Expenses by 8.96% (\$34.22 million) arising from –
 - (i) creation of 6 new posts (\$1.9 million) for the regulation of sponsors and authorization of REITs;
 - (ii) upgrading of 22 posts in various divisions (\$3.6 million) to cope with increasing complexities of the work and responsibilities;

- (iii) additional salary costs arising from filling of vacant posts and full year effect of 19 new posts and 17 upgradings already included in the revised estimates for 2004/05 and approved budget for 2005/06 (\$13.5 million);
 - (iv) a provision of an average of 3% fixed pay adjustment (\$10.7 million) based on findings of three market pay trend surveys which suggested salary increase from 3.3% to 4.5%;
 - (v) increase in provision (\$3.2 million) for awarding variable pay and the total provision sought is about 8% of remuneration budget; and
 - (vi) increase in other personnel expenses (\$1.1 million) mainly due to higher life and medical insurance premium;
- (b) increase in Training and Development expenses by 16.08% (\$1.27 million) to provide more intensive training activities;
 - (c) increase in Professional and Others expenses by 20.12% (\$4.12 million) in anticipation of increase in litigation and higher demand for external consultancy;
 - (d) increase in External Relations expenses by 165.29% (\$10 million) to provide for the hosting of the 2006 IOSCO Annual Conference (\$11.8 million); and
 - (e) contribution to the reserve and operating fund of the Financial Reporting Council (\$5 million was approved in 2005/06 and deferred to 2006/07).

(c) Staff establishment

10. The SFC proposed to increase a total of 6 posts in 2006/07

(paragraph 9(a)(i) above). The total establishment will become 427 (comprising 419 permanent established posts and 8 temporary established posts) by the end of 2006/07.

11. The proposed six new posts are required to cope with –
 - (a) regulation of sponsors including drafting of new codes and guidelines; implementation and maintenance of the new licensing regime; supervision of sponsors and the ongoing surveillance and monitoring of compliance (4 posts); and
 - (b) increase in work load to conduct policy and surveillance work on listed REITS including development of new rules on the market conduct of REITS, disclosure of interests and compliance (2 posts).

The detailed justifications are described in paragraph 22 of the budget at Annex.

12. The 22 posts to be upgraded (paragraph 9(a)(ii) above) include 2 Director posts, 7 Senior Manager posts, 3 Manager posts, 5 Assistant Managers and 5 Officers or General Grades posts in various divisions. The SFC explained that the upgrading is required due to increase in complexities and responsibilities of work involving company inspection, A & H shares, cross-border takeovers, investor education projects, etc.

13. The SFC considered that the proposed new posts and upgrading are necessary and that the requirements cannot be trimmed down through internal redeployment or administrative means.

(d) Staff Salary

14. There has not been any general salary increase in the SFC since April 2001, and its staff did not receive any variable pay award in 2001/02 and 2002/03. Owing to the healthy recovery of our economy and improved market conditions, the SFC has been experiencing staff turnover problem since early 2004. The overall staff turnover in 2005

was 14.11% compared with 11.1% for the same period in 2004. The turnover rate in 2005 for executive and non-executive staff was 16.21% (12.66% for 2004) and 10.24% (10.28% for 2004) respectively. The problem was more serious at Manager and Assistant Manager ranks, which had a turnover ranging from 13% to 29%. Having regard to the high turnover rates, the SFC proposed to –

- (a) include a provision of \$29.5 million for the award of variable pay, which is equivalent to about 8% of the remuneration budget for 2006/07; and
- (b) an average fixed pay adjustment of 3% (\$10.7 million) to bring the pay package in line with the market trends.

15. Members may wish to note that a provision of \$26.3 million, which was equivalent to 8% of the remuneration budget, was approved in the 2005/06 budget as variable pay. Similarly, about 8% (\$29.5 million) of the remuneration budget is included in the budget for 2006/07 as variable pay. The provisions for both the variable pay and fixed pay adjustment are only for budget purpose. The actual number of staff eligible for variable pay and salary adjustment, as well as the actual percentage of variable pay and salary adjustment, will be subject to the approval of the Remuneration Committee of the SFC and the SFC Board.

(e) Estimated capital expenditure

16. The total capital expenditure budget proposed for 2006/07 is \$18.07 million, which includes, among other items –

- (a) a provision of \$9.29 million for the development of web-based application systems and further enhancement of system infrastructure and knowledge-based management;
- (b) a provision of \$5.64 million for office equipment including PCs and other PC peripherals and software; and
- (c) a provision of \$0.5 million for the replacement of furniture due to wear and tear.

A contingency equal to 10% of the estimated capital expenditure (\$1.64 million) is also included.

17. A projected income and expenditure statement and a projected balance sheet for the year 2006/07 are on pages 4.1 and 4.2 of the budget at Annex.

COMPARISON OF THE APPROVED BUDGET WITH THE REVISED ESTIMATES FOR 2005/06

18. The table on page 2.4 of the budget at Annex provides a comparison of the approved budget and the revised estimates for 2005/06. The main features are set out in paragraphs 19 to 21 below.

(a) Revenue

19. The SFC's revenue in 2005/06 has grown significantly, as a result of a substantial increase in levy income due to robust market activities last year and early this year. The revised estimates on revenue for 2005/06 is \$730.19 million, which represents a 42.36% increase above the approved estimates³. Income from securities levy and fees and charges are revised to increase by 48% and 26% respectively. The surplus for the year is now estimated to be \$220.83 million, which is about 46.2 times the approved estimates of \$4.78 million.

(b) Operating expenditure

20. The revised estimates on operating expenditure for 2005/06 is \$485.85 million, which is slightly above the approved estimates by \$4.21 million (0.87%). The increase is mainly attributable to –

- (a) pay rise (\$5.84 million) granted to 152 staff in 11 grades following a special pay review;

³ In the approved estimates for 2005/06, the average daily turnover of securities was assumed to be \$13 billion. The daily turnover of futures and options contracts was assumed to be 49,000.

- (b) increase in training and development expenses by 18.8% (\$1.25 million); and
- (c) increase in external professional services, recruitment and custodian charges by about 7% (\$1.34 million).

The above increases are partially offset by a reduction of expenditure on Corporate Communications (\$0.01 million) and contingency (\$0.75 million).

(c) Capital expenditure

21. The total capital expenditure estimate is slightly reduced from \$16.8 million to \$15.77 million.

ADMINISTRATION'S VIEWS

22. The Administration has examined the SFC budget for 2006/07 and is pleased to note that the SFC has projected a surplus in the budget, and that the SFC, as in the past years, has not requested for appropriation from the Legislative Council.

23. On expenditure, personnel expenses (\$416 million) account for about 77% of the total operating expenditure for 2006/07 and represent an increase of \$34 million or 9% from the revised estimates for 2005/06. The SFC is mindful of the need to exercise vigilant control on staff resources but considered that the increase in staff establishment and the pay rise are necessary to cope with the increase in responsibilities and staff retention problem.

Proposed levy reduction

24. As announced by the Financial Secretary, it is proposed that the levy on securities trading be reduced by 20% from the prevailing rate of 0.005% to 0.004% and that the levy for futures and options contracts also be reduced by 20%. The proposed levy reduction, if implemented, is estimated to reduce the transaction cost to the market by about \$88 million a year, based on SFC's assumption that the average daily turnover

for 2006/07 is \$16.5 billion and that the daily turnover of futures/options contracts is 60,000 contracts.

25. The proposed scale of reduction is considered reasonable having regard to the need to enable the SFC to continue to maintain a healthy financial position.

26. The levy reduction proposals require approval from the Chief Executive in Council pursuant to section 396 of the SFO and the making of an order which would be subject to negative vetting by this Council. The SFC would also need time to allow itself and the market to make necessary accounting preparations before the two reductions proposals could take effect. Subject to approval from the Chief Executive in Council and negative vetting by this Council, the SFC expects to implement the proposals within 2006.

Financial Services Branch
Financial Services and the Treasury Bureau
February 2006

SECURITIES & FUTURES COMMISSION
PROPOSED ESTIMATES OF INCOME & EXPENDITURE
FOR THE FINANCIAL YEAR 2006/2007

CONTENT

<u>Section</u>	<u>Description</u>	<u>Page</u>
1	Executive Summary	1.1 - 1.3
2	Bases of Proposed Estimates and Highlights	2.1 - 2.11
3	Proposed Estimates of Income & Expenditure	
	- Income	3.1
	- Operating Expenditure	3.2
	- Capital Expenditure	3.3
4	Projected Financial Statements	
	- Income & Expenditure Statement	4.1
	- Balance Sheet	4.2

EXECUTIVE SUMMARY

Extract of Proposed Estimates for the Year 2006/2007

	Proposed Estimates <u>2006/2007</u> HK\$'M	Revised Estimates <u>2005/2006</u> HK\$'M	Approved Estimates <u>2005/2006</u> HK\$'M
Revenue	587.17	730.19	512.92
Operating Expenditure	541.87	485.85	481.64
Depreciation	20.00	23.50	26.50
Surplus	25.30	220.84	4.78
Projected reserves at beginning of the year	1,080.92		768.85
Actual reserves at beginning of the year		860.08	
Reserves at end of the year	1,106.22	1,080.92	773.63
Capital Expenditure	18.07	15.77	16.80
Headcount			
Permanent established post	419	413	413
Temporary established post-Special Advisers	2	2	2
Temporary established post-Manager Trainees	6	6	6

Budgetary Strategy

1. In 2006/2007, we shall continue the strategy to tightly control all expenditure having regard to 2005/2006 expenditure level as a bench mark except for areas where additional resources are considered necessary to improve the market quality through further strengthening the Commission's existing teams of staff and to enhance Hong Kong's status as a preferred fund raising centre in the region.
2. On the revenue side, we assume that our levy rate will be reduced by 20% with effect from 1st April 2006. Our securities levy rate will be reduced from 0.005% to 0.004% and our futures/options contract levy rate will be reduced from \$1 and \$0.2 (depending on the type of contracts) to \$0.8 and \$0.16 respectively. Fees and charges level will remain unchanged though they have not been revised since 1993/1994. Same as prior years, we propose not to request for the annual grant from the Government for 2006/2007.
3. We have not factored in the potential resources implication arising from the statutory backing of the HKEx Listing Rules when we prepare the 2006/2007 estimates as we do not know when the related legislation will be passed and to what extent the backing will be given at this stage. However, should the statutory backing of the Listing Rules be materialized during 2006/2007, we will prepare and submit a supplementary budget to the Financial Secretary for approval, if appropriate.

Revenue

4. The estimated revenue for 2006/2007 is \$587.17 million, 19.59% (\$143.02 million) below the revised estimates. In comparison with the revised estimates in 2005/2006, securities levy income will decrease by \$150.6 million, assuming that the levy rate will be reduced from 0.005% to 0.004% with effect from 1st April 2006. The average daily securities turnover for 2006/2007 is assumed to be \$16.5 billion versus \$19 billion assumed in 2005/2006 revised estimate. Levy income from futures/options contracts will decrease by \$7.42 million, assuming that the levy rate will be reduced from \$1 and \$0.2 (depending on the type of contracts) to \$0.8 and \$0.16 respectively, with a projected turnover at about 60,000 contracts per day.
5. Fees and charges income is expected to be higher than the revised estimates of 2005/2006 by 4.89% (\$9 million). Fee income from Licensing is projected to be higher as a more active market in 2004/2005 and 2005/2006 is expected to generate a higher annual fee income from registered persons for 2006/2007. Fee income from Corporate Finance and Investment Products are projected to be the same as in 2005/2006. Investment income is anticipated to remain stable at the 2005/2006 revised level.
6. Furthermore, as in previous years, the Commission will invite the Government not to request any appropriation from the Legislative Council. This decision is made without prejudice to the funding principles established when the Commission was formed, and has no implication for requests for appropriation in future years. It is estimated that the annual government grant foregone by the Commission for 2006/2007 would be around \$84 million, and that the total annual grant foregone since 1993/94 amounted to \$1.1 billion.

Operating Expenditure

7. The total estimated operating expenditure for 2006/2007 (including depreciation and a contingency provision of \$1.5 million) is \$561.87 million, 10.31% (\$52.5 million) higher than the revised 2005/2006 estimates of \$509.35 million. However, if we take out the non-recurrent expenditure for the IOSCO 2006 Conference (\$11.8 million) and the contribution to the reserve and operating fund of the Financial Reporting Council (\$5 million), the net increase is 7.4% (\$37.6 million). The general price increase for the year 2006/2007 is assumed to be at 1.6%. The major changes are noted as follows :
 - (i) Personnel expenses for 2006/2007 are higher than the revised estimate by 8.96% (\$34.22 million). The increase is mainly attributable to the increase in 6 headcounts over the revised 2005/2006 establishment, the full year effect of filling vacancies at the established ranks and the upgrading of 22 posts to reflect increased job complexities and responsibilities. A provision of 3% fixed pay adjustment is also included in the proposed estimates;
 - (ii) External Relations expenses for 2006/2007 are higher than the revised estimate by 165.29% (\$10 million). A provision of about \$11.8 million is included as the preparation costs for hosting the 2006 IOSCO Annual Conference;

- (iii) Professional and Others expenses for 2006/2007 are higher than the revised estimate by 20.12% (\$4.12 million). The increase is mainly attributable to the higher legal fees in anticipation of the increase in litigation under Section 214 (remedies in cases of unfair prejudice, etc. to interests of members of listed corporations, etc.) of the Securities & Futures Ordinance and higher demand for external consultancy for operating divisions to discharge their regulatory functions (e.g. study on the adequacy and effectiveness of the Hong Kong regulatory requirements for investment products, thematic inspection and review of IT environment amongst intermediaries etc.);
- (iv) \$5 million is provided for the Commission's share of contribution to the reserve fund and annual operating fund for the operation of the Financial Reporting Council (the Audit Investigation Board and the Financial Reporting Review Committee) on the assumption that the Financial Reporting Council will start its operation in 2006/2007; and
- (v) increase in training and development expenses (\$1.27 million) mainly due to increase in staff turnover and provision of more intensive training activities for 2006/2007.

Capital Expenditure

8. The total capital expenditure budget proposed for 2006/2007 is \$18.07 million. The proposed budget includes (i) a provision of \$9.29 million for the development of web-based application systems and further enhancement of system infrastructure and knowledge-based management; (ii) a provision of \$5.64 million for office equipment including PCs and other PC peripherals and software; (iii) a provision of \$1 million for the replacement of the 2 Commission cars, which have been in use for 8 years and (iv) a provision of \$0.5 million for the replacement of furniture due to wear and tear. A contingency equal to 10% of the estimated capital expenditure (\$1.64 million) is also included.

Operating Results

9. The projections result in a surplus of \$25.3 million, which will increase the projected reserves from \$1,080.92 million (31st March 2006) to \$1,106.22 million (31st March 2007). On this basis, the projected reserves at 31st March 2007 will be equivalent to about 23.6 months of the proposed annual operating expenditure (including depreciation) for 2006/2007.
10. As always, the projected financial position of the Commission is largely dependent on the level of securities market turnover assumed. It is worth noting that at the reduced levy rate of 0.004%, any change of \$1 billion in the average daily turnover will result in a fluctuation of about \$19.8 million in the total levy received by the Commission for the year 2006/2007, i.e. \$17.5 billion or \$15.5 billion turnover would result in a variation of \pm \$19.8 million in levy income from the budget and increase the projected surplus further to \$45.1 million or reduce it to \$5.5 million.
11. The estimates of revenue are subject to considerable market uncertainty, as they depend on the performance of the major markets and the Hong Kong economy. We shall continue our cost control measures with a view to containing our operating expenditure within our financial means, in particular, the personnel costs notwithstanding the anticipated increasing workload arising from new regulatory initiatives and implementation of the Securities & Futures Ordinance.

BASES OF PROPOSED ESTIMATES AND HIGHLIGHTS

The proposed estimates for the year 2006/2007 are prepared on the following bases :-

Strategy

12. Although market sentiment has improved and we envisage that the Commission is able to sustain a healthy financial position in the coming year, we will continue to exercise stringent controls on our expenditure in 2006/2007. Except for areas where additional resources are considered necessary to improve market quality through further strengthening the Commission's teams of staff and focusing on certain regulatory functions, all expenses are restrained having regard to 2005/2006 revised estimates as a benchmark.
13. We have not factored in the potential resources implication arising from the statutory backing of the HKEx Listing Rules when we prepare the 2006/2007 estimates as we do not know when the related legislation will be passed and to what extent the backing will be given at this stage. However, should the statutory backing of the Listing Rules be materialized during 2006/2007, we will prepare and submit a supplementary budget to the Financial Secretary for approval, if appropriate.
14. On the revenue side, the major income source of the Commission is still investor levies which are dependent on market turnovers. We assume that our levy rate will be reduced by 20% with effect from 1st April 2006. The securities levy rate will be reduced from 0.005% to 0.004% on each stock exchange transaction. Levy from futures/option contracts will be reduced from \$1 and \$0.2 (depending on the type of contracts) to \$0.8 and \$0.16 respectively. The Commission proposes not to request for the annual grant from the Government for 2006/2007. Our fee levels will remain unchanged though they have not been revised since 1993/1994.

Assumptions

15. Price Increase

The general price increase for the year 2006/2007 is assumed to be at 1.6%, using the percentage increase in Composite CPI at September 2005 compared with September 2004 as a reference.

16. Remuneration Adjustment

A 3% provision is included for general salary increase in the proposed 2006/2007 budget.

17. Interest Rate

The average return of dated securities is assumed at 3.5%-4% p.a. and the yield on deposits is assumed to be 4% p.a. for the year 2006/2007.

18. Levy Rate

There will be a 20% cut in levy rate with effect from 1st April 2006. The securities levy rate will be reduced from 0.005% to 0.004%. The futures/options contract levy rate will be reduced from \$1 and \$0.2 (depending on the type of contracts) to \$0.8 and \$0.16 respectively.

19. Funding for the Financial Reporting Council (FRC)

It is expected that the FRC will commence operation in 2006/2007. \$5 million is provided to cover the Commission's contribution towards the reserve fund and the annual operating costs of the FRC.

20. Capital Expenditure

It is assumed that the approved estimates of capital expenditure for different capital projects will, as previously, be carried forward until the completion of the projects.

21. Manpower Plan

The manpower plan for 2006/2007 which is based on the assessment of staff strength required to discharge the Commission's existing regulatory functions is outlined below :

Division	Function	Proposed Establishment for 2006/2007 (Note 2)	Revised Establishment for 2005/2006 (Note2)	Approved Establishment for 2005/2006
Chairman's Office	Division Management & Commission Secretariat	11	11	12 (Note 1)
Corporate Finance	Corporate Finance	56	56	56
Intermediaries & Investment Products	Division Management	16	10	10
	Licensing	33	33	33
	Intermediaries Supervision	66	66	66
	Investment Products	28	28	28
Enforcement	Enforcement	93	93	92 (Note 1)
Supervision of Markets	Supervision of Markets	19	19	19
	Research	4	4	4
Legal Services	Legal Services	17	17	17
Corporate Affairs	Corporate Communications	14	14	14
	Investor Education & Communications	13	13	13
	Information Technology	18	18	18
	Finance & Administration	19	19	19
	Human Resources & Training & Development	12	12	12
Permanent Established Posts		419	413	413
Temporary Established Posts:	Special Advisers	2	2	2
	Manager Trainees	6	6	6
TOTAL		427	421	421

Note 1 : The approved establishment for Chairman's Office and Enforcement for 2005/2006 was 12 and 92 respectively. One executive post was subsequently transferred from Chairman's Office to Enforcement in July 2005 to head the international team, handle some of the disciplinary team's casework and also involve in sponsors regulation policy work on the necessary legislative amendments. This results in a change in headcount of Chairman's Office and Enforcement to 11 and 93 respectively.

Note 2: The revised staff complement for 2005/2006 is 413 Permanent Established Posts plus 8 Temporary Established Posts (2 Special Advisers and 6 Manager Trainees) and 24 temporary staff.

The proposed staff complement for 2006/2007 is 419 Permanent Established Posts plus 8 Temporary Established Posts (2 Special Advisers and 6 Manager Trainees) and 24 temporary staff.

Separately, 14 executive trainees are included in and funded out of the SFC Internship Programme under Training and Development expenditure in both financial years 2005/2006 and 2006/2007.

22. Except for Intermediaries and Investment Products division, we do not propose any change in the establishment for other divisions within the Commission for 2006/2007. Six additional headcounts are proposed in the Intermediaries and Investment Products division. Four of them will be responsible for the second stage of regulation of sponsors, which involves the drafting of new codes and guidelines, implementation and maintenance of the new licensing regime, vigorous supervision of sponsors and the ongoing surveillance and monitoring of compliance. Two executive posts are required to conduct policy and surveillance on listed REITS and their related listed companies. All the six additional posts will be included under divisional management for more flexibility in deploying resources within the division.

23. Following is a summary of major estimate items :-

	(A)	(B)	(C)	(A)-(B) (B)	(B)-(C) (C)
	Proposed Estimates For Year <u>2006/2007</u> HK\$'000	Revised Estimates For Year <u>2005/2006 *</u> HK\$'000	Approved Estimates For Year <u>2005/2006</u> HK\$'000	Proposed Estimates Over/(Under) Revised Estimates %	Revised Estimates Over/(Under) Approved Estimates %
<u>REVENUE</u>					
Investor Levy					
Securities	327,360	477,957	322,400	(31.51)	48.25
Futures/Options Contracts	23,808	31,229	24,304	(23.76)	28.49
Fees & Charges	193,000	184,000	146,016	4.89	26.01
Investment Income	34,000	34,000	18,400	--	84.78
Other Income	<u>9,000</u>	<u>3,000</u>	<u>1,800</u>	200.00	66.67
Total	<u>587,168</u>	<u>730,186</u>	<u>512,920</u>	(19.59)	42.36
<u>OPERATING EXPENDITURE</u>					
Premises	35,847	35,232	35,202	1.75	0.09
Personnel Expenses	415,943	381,726	375,893	8.96	1.55
Info. & Sys. Services	20,050	18,975	18,205	5.67	4.23
General Office & Insurance	7,045	7,380	7,280	(4.54)	1.37
Training & Development	9,170	7,900	6,650	16.08	18.80
Professional & Others	24,621	20,497	19,156	20.12	7.00
Corporate Communications	3,046	3,142	3,153	(3.06)	(0.35)
External Relations	16,050	6,050	6,000	165.29	0.83
SCEFI	3,600	4,200	3,600	(14.29)	16.67
Funding for the FRC (the AIB and FRRC)	<u>5,000</u>	<u>--</u>	<u>5,000</u>	N/A	N/A
Sub-total	540,372	485,102	480,139	11.39	1.03
Contingency	<u>1,500</u>	<u>750</u>	<u>1,500</u>	100.00	(50.00)
Total	<u>541,872</u>	<u>485,852</u>	<u>481,639</u>	11.53	0.87
DEPRECIATION	20,000	23,500	26,500	(14.89)	(11.32)
SURPLUS	25,296	220,834	4,781	(88.55)	4,518.99
<u>CAPITAL EXPENDITURE</u>					
Furniture & Fixtures	500	1,000	1,000	(50.00)	--
Office Equipment	5,640	3,860	3,860	46.11	--
Vehicles	1,000	--	--	N/A	--
Computer Sys. Development	<u>9,290</u>	<u>10,410</u>	<u>10,410</u>	(10.76)	--
Sub-total	16,430	15,270	15,270	7.60	--
Contingency	<u>1,643</u>	<u>500</u>	<u>1,527</u>	228.60	(67.26)
Total	<u>18,073</u>	<u>15,770</u>	<u>16,797</u>	14.60	(6.11)

* The revised estimates for the year 2005/2006 were derived from a review undertaken in November 2005 of the approved estimates for the year 2005/2006.

REVENUE

Annual Grant from Government

24. S.14 of the Securities and Futures Ordinance provides that : “For each financial year of the Commission, the Government shall pay to the Commission out of the general revenue the moneys appropriated by the Legislative Council for that purpose.” The Commission will ask the Government not to request an appropriation from the Legislative Council for the financial year 2006/2007. The Commission’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.
25. Should a request for an appropriation be made, it would be provisionally assessed at about \$84 million. The assessment is based on the principle that the annual grant would be equivalent to the net cost to Government for funding the former Office of the Commissioner of Securities, adjusted annually from 1988/89 prices by reference to adjustments in levels of Government civil service salaries, rent and the general rate of inflation in Hong Kong. Since 1993/94, the Commission had foregone annual grant amounting to about \$1.1 billion.

Investor Levy - Securities

26. The revised estimate of Investor Levy-Securities is expected to be higher than the approved estimates for 2005/2006 by about 48.25% (\$155.56 million). The robust market activities for the past few months and the optimistic market sentiment pushed the securities market average daily turnover in the first seven months of 2005/2006 to about \$19.9 billion, 53% higher than the \$13 billion/day assumed in the approved estimate. The average daily turnover for the rest of the year is assumed to be \$18 billion.
27. The average daily turnover for projecting Investor Levy - Securities for 2006/2007 is assumed to be \$16.5 billion, which is 13.16% lower than the average daily turnover of \$19 billion of the revised estimates for 2005/2006. By the end of October 2005, our reserves has exceeded the two times threshold of our annual operating expenditure estimates. In the circumstances, we are obliged, under Section 396 of the Securities and Futures Ordinance, to review the rate of levy and to consult the Financial Secretary with a view to recommending to the Chief Executive in Council that the rate of levy be reduced. We are going to recommend to the Chief Executive in Council to reduce the rate of levy from the prevailing 0.005% to 0.004% with effect from 1st April 2006. On this basis, levy income from securities is projected to be \$327.36 million, about 31.5% (\$150.6 million) lower than the 2005/2006 revised estimate. 248 trading days are assumed in the proposed estimates for 2006/2007.

Investor Levy - Futures / Options Contracts

28. The revised estimate of Investor Levy - Futures / Options Contracts is higher than the approved estimate by about 28.49% (\$6.93 million). The increase reflects the higher than expected average daily turnover on the Futures Exchange during the first seven months of the year 2005/2006 (average 63,000 contracts cf. 49,000 contracts in the approved estimates). Daily turnover for the period November 2005 to March 2006 (104 trading days) is assumed at 60,000 contracts.
29. For 2006/2007, levy income from futures/options contracts will decrease by 23.76% (\$7.42 million) as compared to the revised 2005/2006 estimate, assuming that the levy rate will be reduced from \$1 and \$0.2 (depending on the type of contracts) to \$0.8 and \$0.16 respectively with effect from 1st April 2006, with a projected turnover at about 60,000 contracts per day.

Fees and Charges

30. The revised estimates of overall fees and charges for the year 2005/2006 are higher than the approved estimate of \$146.02 million by 26.01% (\$37.98 million). Major increase stemmed from higher than expected licensing applications received and more corporate finance activities.
31. For 2006/2007, the fees and charges income is projected to be about \$193 million, higher than the revised 2005/2006 estimate by 4.89% (\$9 million). The projected fee income from Licensing for 2006/2007 is higher than the 2005/2006 revised estimate by \$9 million. A more active market in 2004/2005 and 2005/2006 is expected to generate a higher annual fee income from registered persons for 2006/2007. The projected income from Investment Products and Corporate Finance remains at the same level as the 2005/2006 estimates.

Investment Income

32. Investment income includes the return on the investment portfolio operated under the advice of an external advisor after taking into account the amortization of premium or discount on purchases of dated securities. It also includes interest earned on deposits placed out of in-house funds.
33. The revised estimate for 2005/2006 is higher than the approved estimate by about 84.78% (\$15.6 million) because of higher interest rate and the increase in available sum for investment resulting from a more favourable operating result. The average return on dated securities and deposits are expected to stay within the range of 3.5% - 4% p.a. for the rest of the financial year.
34. Having taken into account the operating results projected for 2005/2006 and 2006/2007, investment income is expected to remain at the same level as the revised 2005/2006 estimates. The average rate of return of dated securities is estimated to be 3.5%-4% p.a. and the yield on bank deposits is assumed at 4% p.a..

Other Income

35. Miscellaneous income for 2005/2006 is revised upward by 66.67% (\$1.2 million) as we have a higher than expected recovery from investigation cases in the first seven months of the financial year.
36. Other income, including the registration fee for IOSCO 2006 Conference (\$6 million), is estimated to be \$9 million for the year 2006/2007.

OPERATING EXPENDITURE

Premises

37. Premises expenses remain steady and we do not expect any major revision in the proposed 2006/2007 estimate.

Personnel Expenses

38. Personnel expenses in the 2005/2006 revised estimates are expected to be higher than the 2005/2006 approved estimates by 1.55% (\$5.8 million). The proposed establishment for the year ending 31 March 2006 remains at the approved level of 421 (including 2 special advisers and 6 manager trainees). The increase in personnel expenses mainly reflects the special pay review during the year for selected grades to catch up with the market pay level as a measure to retain experienced staff.
39. The estimates of personnel expenses for 2006/2007 are higher than the 2005/2006 revised estimate level by 8.96% (\$34.22 million). The projected headcount at 31 March 2007 will be 427 (419 permanent established posts plus 8 temporary established posts), an increase of 6 over the approved (and revised) establishment of 421 at 31 March 2006. Six executive posts are proposed for the Intermediaries and Investment Products division and will be included under divisional management for more flexibility in deploying resources within the division. The estimated additional expenditure for the six new headcount is \$1.9 million. Apart from the increase in headcount, the increase in our proposed expenses is to cover (i) a provision of 3% fixed pay adjustment (+\$10.7 million); (ii) the full year effect of filling vacancies at the established ranks (+\$13.5 million); (iii) upgrading of 22 posts to reflect increased job complexities and responsibilities (+\$3.6 million); and (iv) additional provision for other personnel expenses items (mainly arising from life and medical insurance and temporary staff expense) (+\$1.3 million). We have also included a provision of \$29.5 million (about 8% of remuneration budget) for variable pay award for 2006/2007. Similar provision of \$26.3 million is included in the revised 2005/2006 estimate.

Information and Systems Services

40. The revised 2005/2006 estimate is higher than the approved estimate by 4.23% (\$0.77 million). The upward revision is mainly due to the more extensive use of Blackberry device and service as a wireless e-mail communication solution for senior executives and the subscription of additional information services (such as derivative warrant data) to enhance research capability.

41. The proposed 2006/2007 information and systems services expenses are 5.67% (\$1.08 million) higher than the revised estimate. The increase is mainly due to the higher demand in information services and research facilities arising from operation needs (e.g derivative warrants data) and the expected increase in the costs to secure IT systems contract services from the market.

General Office and Insurance

42. The revised general office & insurance expenses are higher than the approved estimate by about 1.37% (\$0.1 million) to cover the additional insurance coverage for the WTO 6th Ministerial Conference held in December 2005.
43. General Office and Insurance expenses for 2006/2007 are expected to be lower than the revised estimate of 2005/2006 by 4.54% (\$0.34 million). The downward adjustment is attributable to the exclusion of additional insurance premium coverage and contingency provided for the WTO 6th Ministerial Conference to be held in December 2005, which is not expected to repeat in 2006/2007.

Training and Development

44. Training & Development expenses for 2005/2006 are revised upward by 18.8% (\$1.25 million) in order to provide an adequate level of training activities to meet the needs of various levels of staff both in the technical and management areas. Local in-house training expenses are revised upward by 44% (\$0.9 million) to cover industry-related workshop, management training and language training. All the new training programmes were recommended by the Training Committee and endorsed by the Management Committee. Staff functions budget is also revised upward by \$0.15 million to cover mainly the cost of a staff gathering held in an outside venue in September 2005, which was not included in the approved 2005/2006 estimates.
45. Training and Development expenses for 2006/2007 are higher than the revised estimate by about 16.08% (\$1.27 million). The more intensive training activities in 2006/2007 largely explains the increase. An increased training budget is sought to provide an adequate level of training activities to meet the needs of various levels of staff. The increase also takes into account new areas such as corporate regulation, conduct regulation that would call for more training. SFC internship programme expenses are also revised upward by 13.04% (\$0.3 million) to keep the pay level of executive trainees with the market.

Professional & Others

46. Professional & Others expenses are revised upward by about 7% (\$1.34 million) in the revised 2005/2006 estimate. The main increases are in external professional services, recruitment and custodian charges in anticipation of more demand of external consultancy, particularly in the areas of intermediaries supervision and more executive search fees. Such increase will be partially washed out by the projected decrease in legal fees.

47. Professional and Others expenses for 2006/2007 are higher than the revised estimate by 20.12% (\$4.12 million). The increase is mainly attributable to the higher legal fees in anticipation of the increase in litigation under Section 214 (remedies in cases of unfair prejudice, etc. to interests of members of listed corporations, etc.) of the Securities & Futures Ordinance and higher demand for external consultancy for operating divisions to discharge their regulatory functions (e.g. study on the adequacy and effectiveness of the Hong Kong regulatory requirements for investment products; thematic inspection and review of IT environment amongst intermediaries etc.).

Corporate Communications

48. The revised 2005/2006 estimate is comparable to the approved estimate.
49. The proposed 2006/2007 estimate is lower than the 2005/2006 revised estimate by 3.06% (\$0.1 million). The decrease is mainly noted in eIRC maintenance as major website enhancement of eIRC was completed in 2005/2006.

External Relations

50. The revised 2005/2006 expenses are retained at the approved level.
51. External Relations expenses for 2006/2007 are higher than the revised estimate by 165.29% (\$10 million). A provision of about \$11.8 million is included as the preparation costs for hosting the 2006 IOSCO Annual Conference.

SCEFI

52. The 2005/2006 estimate of SCEFI is revised upward by 16.67% (\$0.6 million) to cover the recurring network operation and support expenses plus the additional expenses on FinNet new backbone, external security audit and new server infrastructure for the 5 months to 31 March 2006.
53. The estimate of 2006/2007 is \$3.6 million, 14.29% (\$0.6 million) lower than that assumed in the revised estimate. About \$2.1 million is budgeted to support the operation of FinNet and \$1.5 million is provided for further developing the services range of FinNet and promoting the use of FinNet to market participants.

Funding for the Financial Reporting Council (FRC) (the Audit Investigation Board (AIB) and the Financial Reporting Review Committee(s) (FRRC)

54. The function of the AIB is to investigate suspected irregularities of the auditors of listed corporations and listed collective investment schemes. The ambit of FRRC is to conduct enquiry into the financial reports of such corporations or schemes to ensure that they comply with the relevant legal and accounting requirements. Under the current proposal, a governing board, namely the FRC, will be established to oversee the two bodies and will comprise members appointed by the Government as well as members to be nominated by the relevant parties including the SFC.
55. The annual costs of the operation is preliminarily estimated at \$10 million and will be shared among the HKEx, the accounting profession, the Government and the SFC. Also, a reserve fund of about \$10 million will be set up.
56. As it is expected that the FRC (both the AIB and FRRC) will not commence operation before the second quarter of the year 2006, the provision of \$5 million approved in 2005/2006 is now deferred to 2006/2007 to cover the SFC's contribution towards the reserve fund and the annual operating costs.

Contingency

57. A contingency of \$0.75 million and \$1.5 million is provided for the rest of the year 2005/2006 and the whole year 2006/2007 respectively to cover unforeseen expenses arising from abrupt changes of environment or unforeseen special requirements.

CAPITAL EXPENDITURE

Revised Estimates

58. The total capital expenditure estimate is reduced slightly from \$16.8 million to \$15.77 million as a result of the reduction of contingency provision from \$1.53 million to \$0.5 million.

Proposed Estimates

59. The total proposed capital expenditure budget for 2006/2007 is expected to be \$18.07 million, \$2.3 million higher than the revised 2005/2006 estimates. The 2006/2007 capital expenditure comprises the following :
- (i) \$0.5 million for replacement of existing loose furniture due to normal wear and tear;
 - (ii) \$5.64 million for office equipment which covers (i) the replacement of obsolete servers and notebook computers, network infrastructure enhancement and purchase of PC peripherals for various systems development project planned for 2006/2007 (\$1.98 million); (ii) acquisition of office software, network management software and operating systems (\$3.16 million); and (iii) replacement of existing equipment due to obsolescence (\$0.5 million);
 - (iii) \$1 million for the replacement of the 2 Commission cars. Both cars were purchased in 1997/1998 and have been in use for more than 8 years and become costly and uneconomical to maintain;
 - (iv) \$9.29 million for costs relating to the systems development projects such as human resources management, XBRL/EDGAR, Unicode enablement, centralize of security log and e-payment facility; and
 - (v) a contingency of \$1.64 million, which is equal to 10% of the projected total capital expenditure.

SECURITIES & FUTURES COMMISSION
ESTIMATES OF INCOME FOR THE YEAR 2006/2007

	Proposed Estimates Year 2006/2007 HK\$	Revised Estimates Year 2005/2006 HK\$	Approved Estimates Year 2005/2006 HK\$
Annual Grant from Government	-	-	-
Investor Levy - Securities	327,360,000	477,957,000	322,400,000
Investor Levy - Futures / Options Contracts	23,808,000	31,229,000	24,304,000
Fees and Charges	193,000,000	184,000,000	146,016,000
Investment Income	34,000,000	34,000,000	18,400,000
Other Income	<u>9,000,000</u>	<u>3,000,000</u>	<u>1,800,000</u>
Total	<u><u>587,168,000</u></u>	<u><u>730,186,000</u></u>	<u><u>512,920,000</u></u>

SECURITIES & FUTURES COMMISSION
ESTIMATES OF EXPENDITURE FOR THE YEAR 2006/2007

OPERATING EXPENDITURE

	Proposed Estimates Year 2006/2007 HK\$	Revised Estimates Year 2005/2006 HK\$	Approved Estimates Year 2005/2006 HK\$
Premises	35,847,000	35,232,000	35,202,000
Personnel Expenses	415,943,000	381,726,000	375,893,000
Information & Systems Services	20,050,000	18,975,000	18,205,000
General Office & Insurance	7,045,000	7,380,000	7,280,000
Training & Development	9,170,000	7,900,000	6,650,000
Professional & Others	24,621,000	20,496,800	19,156,000
Corporate Communications	3,046,000	3,142,000	3,153,000
External Relations	16,050,000	6,050,000	6,000,000
SCEFI	3,600,000	4,200,000	3,600,000
Funding for the Financial Reporting Council	5,000,000	-	5,000,000
Sub-total	540,372,000	485,101,800	480,139,000
Contingency	1,500,000	750,000	1,500,000
Total Operating Expenditure	541,872,000	485,851,800	481,639,000

SECURITIES & FUTURES COMMISSION
ESTIMATES OF EXPENDITURE FOR THE YEAR 2006/2007

CAPITAL EXPENDITURE

	Proposed Estimates Year 2006/2007 HK\$	Revised Estimates Year 2005/2006 HK\$	Approved Estimates Year 2005/2006 HK\$
Furniture & Fixtures	500,000	1,000,000	1,000,000
Office Equipment	5,640,000	3,860,000	3,860,000
Vehicles	1,000,000	-	-
Computer Systems Development	<u>9,290,000</u>	<u>10,410,000</u>	<u>10,410,000</u>
Sub-total	16,430,000	15,270,000	15,270,000
Contingency (Note 1)	<u>1,643,000</u>	<u>500,000</u>	<u>1,527,000</u>
Total Capital Expenditure	<u><u>18,073,000</u></u>	<u><u>15,770,000</u></u>	<u><u>16,797,000</u></u>

Note 1 : Contingency is provided for at 10% of the total 2006/2007 capital expenditure (2005/2006 : 10%)

SECURITIES & FUTURES COMMISSION
PROJECTED INCOME & EXPENDITURE STATEMENT
FOR THE YEAR 2006/2007

	Proposed Estimates 2006/2007	Revised Estimates 2005/2006
	HK\$	HK\$
INCOME		
Investor Levy - Securities	327,360,000	477,957,000
Investor Levy - Futures/Options Contracts	23,808,000	31,229,000
Fees & Charges	193,000,000	184,000,000
Investment Income	34,000,000	34,000,000
Other Income	9,000,000	3,000,000
Total Income	<u>587,168,000</u>	<u>730,186,000</u>
EXPENDITURE		
Operating Expenditure	541,872,000	485,851,800
Depreciation	<u>20,000,000</u>	<u>23,500,000</u>
Total Expenditure	<u>561,872,000</u>	<u>509,351,800</u>
RESULT FOR THE YEAR	<u>25,296,000</u>	<u>220,834,200</u>

SECURITIES & FUTURES COMMISSION
PROJECTED BALANCE SHEET
FOR THE YEAR 2006/2007

	Proposed Estimates 2006/2007 HK\$	Revised Estimates 2005/2006 HK\$
Fixed Assets	<u>32,000,000</u>	<u>24,900,000</u>
Net Current Assets	<u>1,074,215,135</u>	<u>1,056,019,135</u>
Net Assets	<u><u>1,106,215,135</u></u>	<u><u>1,080,919,135</u></u>
Representing :		
Reserves		
Government Start-up Grant	<u>42,840,429</u>	<u>42,840,429</u>
Income & Expenditure Account		
Beginning Balance	1,038,078,706	817,244,506
Result for the Year	<u>25,296,000</u>	<u>220,834,200</u>
	<u>1,063,374,706</u>	<u>1,038,078,706</u>
	<u><u>1,106,215,135</u></u>	<u><u>1,080,919,135</u></u>