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Panel on Financial Affairs
Meeting on 7 March 2011

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

Purpose

This paper sets out background information about the Securities and Futures Commission (SFC), in particular the arrangements for funding its operation and scrutiny of its annual estimates. This paper also summarizes the main concerns and views expressed by members when the budgets of SFC for the financial years from 2006-2007 to 2010-2011 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, ten ordinances including SFCO were consolidated and modernized into the Securities and Futures Ordinance (SFO) (Cap. 571), which came into operation on 1 April 2003.

3. The regulatory objectives of the SFC as prescribed in section 4 of the 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 in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

4. Under the SFO¹, 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 the Financial Secretary (FS) with the delegated authority of the CE. The Executive Committee performs administrative, financial and management functions as delegated by the Board of Directors. The internal controls in the SFC are mainly overseen by three committees, namely the Budget Committee, Remuneration Committee and Audit Committee, which review issues and consider matters regarding the annual budget, staff remuneration and auditing respectively.

5. As at 31 March 2010, the actual staff strength of SFC was 501, consisting of 373 professional staff and 128 support staff. The vacancies were 28 and 7 at the professional and support levels respectively. The organizational structure of SFC as at March 2010 is shown in the **Appendix**.

Financial arrangements

6. Section 14 of the SFO provides that the Government shall provide funding to SFC as appropriated by the Legislative Council (LegCo). In practice, SFC has been self-funded through transaction levies and fees charged to market participants since 1993-1994 and thus has not requested for appropriation from LegCo since then.

7. Under section 13(2) of the SFO, SFC is required to submit, not later than 31 December of each year, the estimates of its income and expenditure (budget) for the next financial year² to CE for approval. In 1995, the CE has delegated

¹ Section 1 of Part 1 of Schedule 2 to the Securities and Futures Ordinance (Cap. 571)

² Section 13(1) of the Securities and Futures Ordinance (Cap.571) specifies that the financial year of the SFC

the approval authority to FS. Under Section 13(3) of the 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 the 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 five years, the approved budget of SFC was tabled at a Council meeting in April or May³ and the annual report of SFC was tabled at a Council meeting in between May and July⁴. It is a practice for SFC and the Administration to brief the FA Panel in the month of February or March on the SFC budget and other major initiatives proposed for the next financial year.

Deliberations of the FA Panel

8. The following main concerns and views were expressed by members when discussing the budgets of SFC in the past years.

Levies and fees

9. At the Panel meetings on 2 March 2007 and 28 February 2008, some members noted that the reserves of SFC as at December 2007 and December 2008 far exceeded the two-fold threshold⁵ as specified in the SFO, and called on SFC and the Administration to consider waiving or reducing the levies and fees charged to market participants. A member pointed out that intermediaries were required to pay a licensing fee for each type of regulated activities they carried out under the existing licensing regime⁶, instead of paying a single licensing fee under the old licensing regime. The member asked SFC to examine the possibility of simplifying the licensing and fee regime.

10. Regarding transaction levies⁷, SFC advised that there was no absolute requirement that the rates of levy must be adjusted when the reserve had reached the two-fold threshold. SFC had reviewed the rates of levy and agreed

commences on 1 April.

³ The SFC approved budgets were tabled at the Council meetings on 26 April 2006, 18 April 2007, 16 April 2008, 13 May 2009 and 28 April 2010.

⁴ The SFC annual reports were tabled at the Council meetings on 17 May 2006, 6 June 2007, 11 June 2008, 8 July 2009 and 23 June 2010.

⁵ Under section 396(2) of the Securities and Futures Ordinance (Cap. 571), SFC should consult FS with a view to recommending to the Chief Executive in Council that the rate of levy be reduced if the reserves of SFC has reached a level more than twice its estimated operating expenses for that financial year.

⁶ The existing licensing regime was introduced under the Securities and Futures Ordinance (Cap. 571) and came into operation on 1 April 2003. During the two-year transitional period (1 April 2003 to 31 March 2005), financial intermediaries could convert their licences that were obtained under the old regime. Under the Securities and Futures (Fees) Rules, licensing fees are payable to SFC and, as prescribed in Schedule 3 to the Rules, fees are imposed on the basis of the number of regulated activities.

⁷ Under section 394(1) of the Securities and Futures Ordinance (Cap. 571), a levy at the rate specified by the Chief Executive in Council by order published in the Gazette shall be payable to the SFC by the person so specified by the Chief Executive in Council for the sale and purchase of securities or future contracts.

with the Administration that the reduction was not appropriate in view of the volatile performance of the market.

11. As for licensing fees⁸, SFC advised that the principle of full cost recovery was adopted. Since the full cost in the provision of licensing services had not been recovered, it would not be appropriate to reduce or waive the licence fees. SFC also advised that under the existing licensing regime, licensees were only required to pay for the types of regulated activities in which they were engaged. The existing licensing regime was introduced for the purpose of streamlining the procedures for application for licences rather than to increase SFC's revenue.

12. When the SFC budget for 2009-10 was discussed at the Panel meeting on 26 February 2009, members noted that to help relieve the cost burden on intermediaries amidst the economic downturn, SFC proposed a one-off waiver of the annual licence fees for over 37,000 intermediaries, including licensed corporations, registered institutions, responsible officers and representatives, for one year from 1 April 2009.

13. In discussing the SFC budget for 2010-11, Panel members noted that having regard to the size of its reserves⁹, SFC proposed a 25% reduction in levy rates with effect from 1 October 2010¹⁰ and the arrangement would be reviewed every year. Noting that investment return for the reserves was 2.75% in 2009-10 and assumed to be 2% for 2010-11, some members expressed concern about the relatively low investment return rates and enquired about the feasibility of asking the Hong Kong Monetary Authority (HKMA) to manage SFC's reserves.

14. SFC responded that part of the reserves had been used to finance the Investor Compensation Fund, and would be used to fund the proposed Investor Education Council and Financial Dispute Resolution Centre. Based on an agreement reached with the Government some 10 years ago, SFC could only invest in securities with high credit rating. SFC was discussing with the Government on the investment arrangements and the possibility of using the reserves to make investments in property was being considered. In addition, SFC explained that since SFC was an independent statutory body, the option of placing investments with HKMA was not open to it.

Employment-related issues and manpower planning

⁸ Under section 395(1)(a) of the Securities and Futures Ordinance (Cap. 571), the Chief Executive in Council may, after consultation with the SFC, make rules to require and provide for the payment to the SFC of fees.

⁹ As at end December 2009, the reserves of SFC was about \$5.8 billion, which was 7.3 times of the revised operating expenditure of SFC for 2009-2010.

¹⁰ The new levy rates took effect on 1 October 2010 after the enactment of the Securities and Futures (Levy) (Amendment) Order 2010.

Post-termination employment of senior executives

15. At the Panel meeting on 6 March 2006, some members considered that SFC should put in place adequate safeguards to prevent conflict of interest in the post-termination employment of their senior executives. SFC advised that all SFC employees were bound by the statutory provisions on secrecy and conflict of interest under sections 378 and 379 of the SFO. Non-compliance with these statutory provisions would constitute criminal offences. SFC had subsequently provided supplementary information¹¹ on the policy governing the post-termination employment of SFC's senior executives and details of the cases of post-termination employment of its senior executives in the three years from 2003-04 to 2005-06.

Staff turnover and recruitment

16. In discussing the SFC Budget for 2007-08, Panel members expressed concern about the high staff turnover rate in 2006 (13-14%) and urged SFC and the Administration to ensure that there were adequate manpower resources for SFC to perform and cope with changing demands of the financial market effectively. SFC responded that apart from a 5% pay increase, it had implemented a number of measures on staff retention, and assured members that it would keep its manpower provision under review and make necessary adjustments to cope with changing demands of the financial market.

17. At the Panel meeting on 1 March 2010, members noted that SFC had 41 existing vacancies, and proposed to create 51 new posts in 2010-11 to cope with the increase in workload. Panel members enquired about the staff recruitment situation and SFC's personnel management strategy, and whether the provision of \$2.5 million for "strategic adjustment"¹² had been properly endorsed. SFC responded that its budget had been vetted by the relevant committees and endorsed by the Board of SFC. SFC had experienced difficulties in recruiting suitable candidates to fill the existing vacancies and might have difficulty in recruiting staff to fill the proposed new posts. According to an independent consultant report presented to the Remuneration Committee of SFC, there were a significant number of high performing staff in SFC who were remunerated well below or just at the market rate. Although many investment banks had laid off their staff during the global financial crisis, most of the laid off banking staff were traders and SFC had to compete with the relevant financial institutions for personnel with experience in financial

¹¹ LC Paper No. CB(1)1186/05-06(03) on "Policies on remuneration for and post-termination employment of senior executives of the SFC" prepared by SFC dated 27 March 2006.

¹² According to LC Paper No. CB(1)1213/09-10(02) prepared by the Financial Services and the Treasury Bureau, the provision was used to enhance the pay band structure and align salary lever of individuals with the market norm.

regulatory work. Most vacancies of SFC occurred at the manager and senior manager levels, and its strategy was to build up a bigger pipeline of the junior management grade staff so as to meet the manpower requirements at the middle management level.

Variable pay component

18. Panel members noted that the remuneration package of SFC's staff included fixed and variable pay components, and asked at the meetings on 26 February 2009 and 1 March 2010 whether such arrangement was necessary. SFC responded that such arrangement was a human resource management tool to drive staff performance, as the variable pay component was performance related. The variable pay component constituted about 9% to 25% of the pay packages for junior and senior staff respectively.

Staff secondment/attachment arrangements

19. At the Panel meeting on 28 February 2008, members expressed concern on whether there were adequate resources and necessary expertise in SFC to cope with the significant increase in the volume and complexity of China market-related issues. SFC acknowledged that it was not easy to recruit staff of the right calibre and expertise to take up China-related regulatory affairs. Nevertheless, as a senior member of staff from the China Securities Regulatory Commission was working in SFC on secondment, SFC could avail itself of his knowledge and expertise in Mainland-related regulatory matters. SFC would also strengthen internal staff training in this area.

20. At the Panel meeting on 1 March 2010, a member opined that arrangements should be made for government officers to be attached to SFC to enhance the officers' experience in market regulatory work. SFC responded that arrangements had been made for a senior manager of SFC to be seconded to the Financial Services and the Treasury Bureau on a rotation basis, and consideration was being given to arranging an Administrative Officer to be seconded to SFC.

Investor protection

21. Regarding the large number of complaints relating to Lehman Brothers Minibonds and structured financial products following the collapse of Lehman Brothers, some members opined at the Panel meeting on 26 February 2009 that additional manpower resources such as contract or temporary staff should be provided for coping with the increased workload in complaint handling. They urged SFC to make effort to expedite the complaint handling and investigation process to meet public expectations. SFC responded that they would request for

additional provisions if additional manpower was required for handling the complaints. SFC had subsequently provided supplementary information on the progress of its investigation into the Lehman incident and its other enforcement work.¹³

22. At the Panel meeting on 1 March 2010, a member asked whether SFC had the power to initiate a derivative action on behalf of a company. The Administration responded after the meeting that SFC was not statutorily empowered to do so¹⁴.

Office premises

23. At the meeting on 28 February 2008, some Panel members suggested that SFC should consider leasing offices in districts with lower office rentals than those in Central, SFC advised that the leases of its offices in both Chater House and Li Po Chun Chamber would be due for expiry in 2013, and SFC would take the opportunity to review its accommodation needs.

Recent development

24. SFC and the Administration will brief the Panel on SFC's budget for the financial year 2011-12 on 7 March 2011.

Relevant papers

25. The relevant papers are available at the following links:

Minutes of the FA Panel meeting on 7 March 2005 (Paragraphs 5 to 31)
<http://www.legco.gov.hk/yr04-05/english/panels/fa/minutes/fa050307.pdf>

Administration's paper on "Securities and Futures Commission budget for the financial year 2005-06" (Feb 2005)
<http://www.legco.gov.hk/yr04-05/english/panels/fa/papers/fa0307cb1-1020-3e.pdf>

Minutes of the FA Panel meeting on 6 March 2006 (Paragraphs 8 to 24)
<http://www.legco.gov.hk/yr05-06/english/panels/fa/minutes/fa060306.pdf>

Administration's paper on "Securities and Futures Commission budget for the financial year 2006-07" (Feb 2006)
<http://www.legco.gov.hk/yr05-06/english/panels/fa/papers/fa0306cb1-997-3e.pdf>

¹³ LC Paper No. CB(1)1173/08-09(04) prepared by SFC

¹⁴ LC Paper No. CB(1)1462/09-10(1) prepared by the Financial Services and the Treasury Bureau

SFC's letter on "Policies on remuneration for and post-termination employment of senior executives of the SFC" (March 2006)

<http://www.legco.gov.hk/yr05-06/english/panels/fa/papers/facb1-1186-3e.pdf>

Minutes of the FA Panel meeting on 2 March 2007 (Paragraphs 38 to 52)

<http://www.legco.gov.hk/yr06-07/english/panels/fa/minutes/fa070302.pdf>

Administration's paper on "Securities and Futures Commission budget for the financial year 2007-08" (Feb 2007)

<http://www.legco.gov.hk/yr06-07/english/panels/fa/papers/fa0302cb1-1007-6-e.pdf>

Minutes of the FA Panel meeting on 28 February 2008 (Paragraphs 24 to 48)

<http://www.legco.gov.hk/yr07-08/english/panels/fa/minutes/fa080228.pdf>

Administration's paper on "Securities and Futures Commission budget for the financial year 2008-09" (Feb 2008)

<http://www.legco.gov.hk/yr07-08/english/panels/fa/papers/fa0228cb1-822-5-e.pdf>

Minutes of the FA Panel meeting on 26 February 2009 (Paragraphs 35 to 46)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/minutes/fa20090226.pdf>

Administration's paper on "Securities and Futures Commission budget for the financial year 2009-10" (Feb 2009)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0226cb1-854-4-e.pdf>

SFC's reply with regard to the number of Lehman-related complaint cases awaiting investigation and related manpower deployment (Feb 2009)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0226cb1-1173-4-e.pdf>

Minutes of the FA Panel meeting on 1 March 2010 (Paragraphs 32 to 47)

<http://www.legco.gov.hk/yr09-10/english/panels/fa/minutes/fa20100301.pdf>

Administration's paper on Securities and Futures Commission Budget for the Financial Year 2010-11

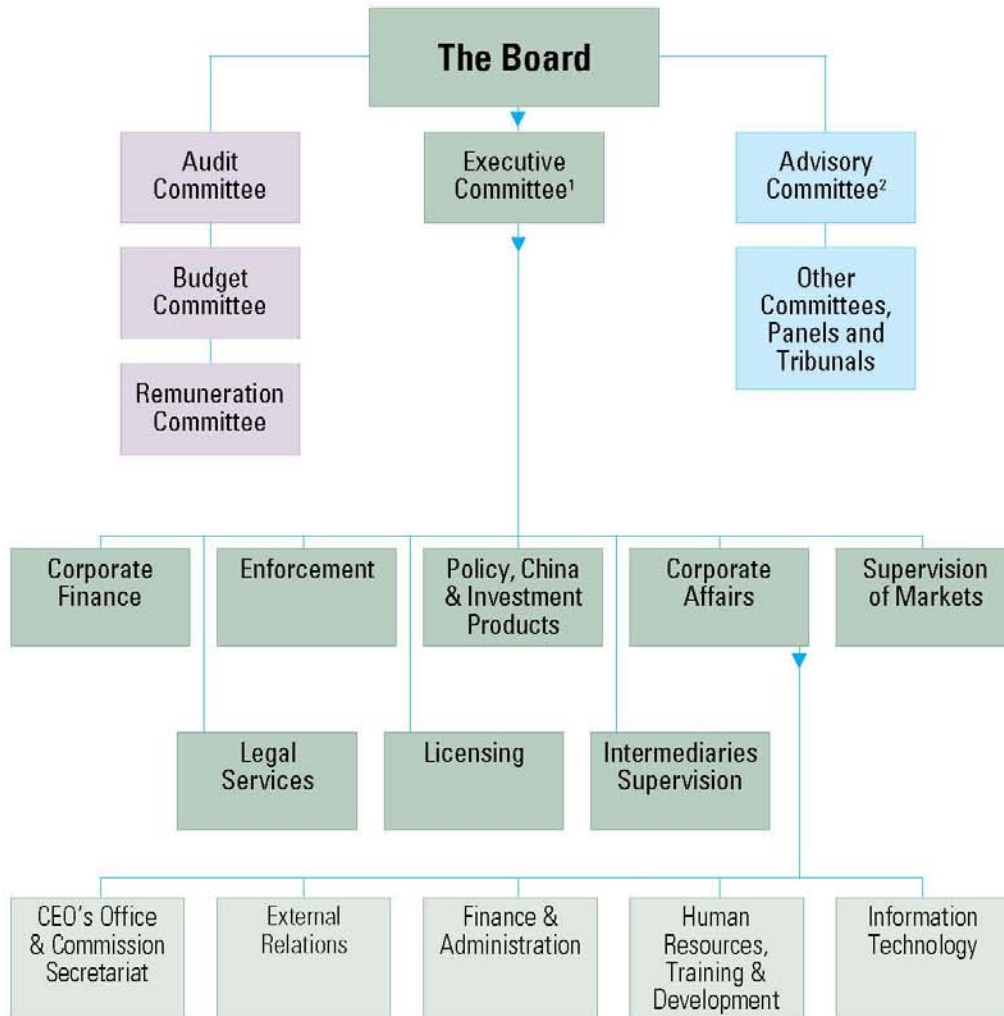
<http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/fa0301cb1-1213-2-e.pdf>

Administration's response on whether the Securities and Futures Commission has power to initiate derivative actions and root cause of the suspension of dissemination of Hang Seng family of indexes on 22 January 2010

<http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/fa0301cb1-1462-1-e.pdf>



Our structure



Members of the Audit Committee and the Remuneration Committee consist of NEDs only, and members of the Budget Committee consist of both NEDs and EDs

Members of these committees consist of academics and industry experts in their respective fields

¹ The Executive Committee consists of:

- the CEO,
- the EDs, senior directors and the Chief Counsel who head the different functions.

² The Advisory Committee is set up according to the requirements stated in the Securities and Futures Ordinance.