Legislative Council Panel on Financial Affairs

Securities and Futures Commission
Budget for the Financial Year 2011-12

PURPOSE

The purpose of this paper is to highlight the main features of the budget of the Securities and Futures Commission ("SFC") for 2011-12.

BACKGROUND

2. Section 13(2) of the Securities and Futures Ordinance (Cap. 571) ("SFO") requires the SFC to submit the 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 brief Members on the main features of the SFC's budget for 2011-12, a copy of which is attached at the Annex.

FUNDING OF THE SFC

3. Section 14 of the SFO 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. Its funding basically comes from the market in the form of levies, fees and charges.

4. Over the years, levies on securities transactions and futures and options contracts have been the main source of income for the SFC. The current rate of levy on securities transactions is 0.003% while that on futures and options contracts is $0.6 or $0.12 per leviable transaction, depending on the type of contracts.

BUDGET FOR 2011-12

5. The SFC has projected a budget surplus of $589.06 million for 2011-12. With the projected budget surplus and sizable reserves, for the nineteenth year in a row, the SFC does not request for any appropriation from the Legislative Council for the 2011-12 budget. The main features of the 2011-12 budget are set out in paragraphs 6 to 11 below.

Estimated Revenue

6. The estimated revenue for 2011-12 is $1,644.24 million, which is 2% more than the revised estimates for 2010-11 ($1,608.29 million), assuming that –

(a) levy income from securities transactions and futures and options contracts will decrease by $39.10 million (3.0%), due to full-year effect of a 25% levy reduction which took effect from 1 October 2010, the effect of which will be partly offset by increased market activities with average daily turnover estimated at $81 billion for securities transactions and 205 000 contracts for futures and options; and

(b) income from fees and charges will be $72.8 million (42.8%) higher than the 2010-11 revised estimates, due to full-year effect in 2011-12 of resuming collection of annual licence fees from intermediaries from 1 April 2010 after the one-off fee waiver in 2009-10[1].

Estimated Expenditure

7. The estimated expenditure for 2011-12 is $1,055.18 million, which is $174.28 million (19.8%) above the 2010-11 revised estimates ($880.90 million). The increase is mainly attributable to –

[1] In accordance with SFC's established accounting practice, annual licence fees received is apportioned over the 12-month validity period of the licence.

(a) increase in Staff Cost by $108.14 million (17.5%) arising mainly from –

(i) a net increase of $47.5 million for 61 new posts to meet the demand in the areas of regulatory reform, enhanced enforcement and supervisory capabilities and organisational improvements;

(ii) a provision of $30.9 million for annual pay review, i.e. an amount equivalent to 5% of staff payroll; and

(iii) a provision of $17.7 million for strategic adjustment to deal with the structural problem within the current pay band structure, and align salary level of affected ranks closer with the market norm;

(b) increase in Professional and Other Expenses by $12.75 million (28.9%) due to the increase in demand for external expert services, especially in the areas of investigation, supervision of intermediaries and new products; and

(c) increase in Funding to External Parties by $46.4 million from $4.59 million to $51 million. New commitments include provision for the set-up and initial operating costs of the proposed Investor Education Council ($37 million) and Financial Dispute Resolution Centre ($8 million).

Staff Establishment

8. The SFC has an establishment of 587 posts under the approved estimates for 2010-11. The SFC proposes a net increase of 61 new posts in the budget of 2011-12 (paragraph 7(a)(i) above refers). The new positions are required mainly to cope with the increase in workload in the following areas –

(a) **Enforcement Division** (15 posts) – to provide a new team to cope with both the new cases and a wide portfolio of current ones. Also to strengthen support in dealing with the increasing number of potential cases for disciplinary action;

(b) **Policy, China & Investment Products Division** (14 posts) – to address challenges posed by complex products and Renminbi-denominated investment products, and to support the policy initiatives for developing Hong Kong into a premier asset management centre;

(c) **Intermediaries Supervision Division** (12 posts) – to increase the division's capacity in the light of increasing challenges for regulating and supervising licensed corporations. Key objectives include conducting more thematic reviews on topical issues, more frequent inspections of high risk/impact firms and more inspections focusing on conduct issues;

(d) **Corporate Affairs Division** (7 posts) – to strengthen support in the areas of translation, complaints handling, human resources, accounting and information technology, etc;

(e) **Licensing Division** (6 posts) – to handle the increasing number of licence applications and additional work relating to the licensing of Credit Rating Agencies;

(f) **Legal Services Division** and the **Office of the Chief Executive Officer and the Commission Secretariat** (4 posts) – to cope with the increase in civil litigations and in-house advisory work, and to enable the SFC to monitor risk and implement corporate strategy more effectively by setting up two centralised teams to handle strategy and risk management and attend to growing international work; and

(g) **Corporate Finance Division** and **Supervision of Markets Division** (3 posts) – to support investigation of takeover cases and increasing work related to Initial Public Offerings, as well as to cope with increasing workload on regulatory reforms and related legislative amendments.

Altogether the headcount for the SFC will increase to 648 under the proposed budget for 2011-12.

Surplus and Reserves

9. As at end December 2010, the reserves of the SFC reached $6,743.59 million. The SFC estimates that by 31 March 2011, the reserves will reach $6,749.63 million, which is 7.7 times of the expenditure of the 2010-11 revised estimates ($880.90 million).

10. According to section 396 of the SFO, the SFC may consult the Financial Secretary with a view to recommending to the Chief Executive in Council that the rate or amount of levy be reduced if the reserves of the SFC are more than twice its operating expenses for that financial year. SFC had proposed a levy reduction of 25% in the 2010-11 budget, which was effected in October 2010. The SFC will continue to closely monitor the level of its reserves.

Estimated Capital Expenditure

11. The total capital expenditure budget proposed for 2011-12 is $58.12 million, representing an increase of $14.38 million (32.9%) above the revised estimates for 2010-11 ($43.74 million). Provisions for major capital items include the following and a 10% contingency -

(a) technological improvement to upgrade SFC's market surveillance capabilities, improve access and exchange of information with stakeholders, integrate licensing systems and enhance various systems in investigation management, etc. ($37.77 million); and

(b) replacement of obsolete office furniture, fixtures and equipment, and continuation of the project to enhance storage technology and data base capacity ($15.07 million).

COMPARISON OF THE APPROVED ESTIMATES WITH THE REVISED ESTIMATES FOR 2010-11

Revenue

12. The revised estimated revenue for 2010-11 is $1,608.29 million, representing a 3.3% decrease from the approved estimates due to lower-than-expected market activities[2] and lower annual licensing fees recognised. The surplus for the year is estimated to be $727.39 million, which is 5.2% below the original estimates of $767.43 million.

Expenditure

13. The revised estimated expenditure is $880.90 million, which is $14.44 million (1.6%) below the approved estimates ($895.34 million). The decrease is mainly attributable to the lower staff cost (by $13.97 million) arising from the time lag in filling vacancies and savings in Professional and Other Expenses (by $3.62 million) through recovery of legal costs.

Capital Expenditure

14. The total capital expenditure estimate is expected to decrease from $44.18 million to $43.74 million (1.0%) mainly arising from a reduction in contingency provision.

ADMINISTRATION’S VIEWS

15. The Administration has examined the SFC’s proposed budget for 2011-12. We note that the SFC has projected a surplus in its budget; and as in the past years, it has not requested for appropriation from the Legislative Council.

16. On the increase in staff cost, we note that the increasing volume and complexity of regulatory activities and the global financial

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[2] The revised estimates for 2010-11 assumed the average daily turnover of securities transactions to be $79 billion for the second half of the year (actual turnover of $65.7 billion for the first half as against budget of $74 billion) and futures and options contracts to be 182 000.

reforms could put pressure on the SFC, and additional manpower would be required to meet new challenges.

ADVICE SOUGHT

17. Members are invited to note the proposed budget of the SFC for 2011-12.

Financial Services Branch
Financial Services and the Treasury Bureau
February 2011

Annex

Securities and Futures Commission

Budget of income and expenditure

for the financial year 2011/2012

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1. Approach and overview of 2011/12 budget

1.1 Each year the budget is prepared based on a policy of tightly controlling all expenditure, as befits a publicly funded organization. Prior year expenditure levels are utilized as a benchmark except in areas where additional resources have clearly been identified as necessary to meet our regulatory obligations or to support initiatives to modify and strengthen the regulatory environment. During the year strict controls are exercised to ensure that costs stay within budget commitments.

1.2 The budget this year follows a period of intense activity for the Commission and reflects our view of the challenges that the organisation will face in the next financial year. The regulatory environment continues to be very challenging, given the uncertainties surrounding the global financial markets and ongoing efforts by regulators to address the problems identified in the global financial crisis. This budget represents our best estimate of the resource implications for the organisation in the immediate future, based on information available at the time of preparation.

1.3 However, in this period of heightened regulatory initiatives and reforms, the increasing possibility of unanticipated resource requirements must be recognised. Should any such matters arise they will be dealt with through a separate interim budget request to the Board depending on their significance. In this connection we specifically note the ongoing discussions regarding the introduction of legislation governing the disclosure of Price Sensitive Information (PSI), and the associated manpower needs in various divisions which require attention closer to the time of the introduction of the PSI.

1.4 At the macro level, the regulatory and financial market landscape is expected to be transformed in the years ahead, as a result of global efforts to cope with the aftermath of the global financial crisis and the growing prominence of the Asian economy, in particular the rapidly growing economic influence of the Mainland. The regulatory and supervisory challenges posed by these developments will shape the resources needs of the Commission.

1.5 The three main drivers of the Commission's talent and resources requirements are:

1.5.1 First, continued expansion of market activities

(a) Asian economic prospects, in particular in Mainland China, are very promising and Asia is expected to be the major contributor to global economic growth. Capital and financial institutions seeking to benefit from the opportunities that Asia presents will gravitate to Hong Kong, as it is the hub for international finance in Asia and the bridge to the Mainland. The demands on the daily operations of the Commission – licensing, supervision, product authorisation, listing activities, and enforcement – will grow in tandem, and the Commission has to ensure that it is adequately resourced to maintain effective regulation and supervision.

(b) In addition, the Commission's own domestic financial reforms post the Lehman Minibond incident would require our capabilities to be bolstered to take on the additional tasks that flow from our new initiatives: (i) the revised Code of Conduct in respect of the selling practices of intermediaries and (ii) the new product handbook for the regulation of unlisted structured products and the authorisation of new product types including RMB products and structured funds.

1.5.2 Second, global financial reforms

(a) Following the global financial crisis, international efforts have been focused on global financial reforms to strengthen the resilience of the global financial system and prevent the recurrence of a similar financial and economic crisis of such magnitude and severity.

(b) These reforms would expand the perimeter of regulation: (i) beyond the traditional sphere of regulation to encompass unregulated markets and products (OTC derivatives) and entities (hedge funds, credit rating agencies); (ii) beyond national borders in the form of closer global cooperation and exchange of information among regulators for more effective supervision of global systemically important financial institutions; and (iii) beyond the soundness of individual institutions to include the monitoring, mitigation and management of systemic risk within the remit of securities regulators.

(c) As a member of the Financial Stability Board, which is expected to lead by example in embracing international standards and recommendations that emerge from these global financial reforms, Hong Kong (hence the Commission) will have to face this regulatory challenge. The Commission has to gear up its human resources to implement these regulatory reforms.

1.5.3 Third, the Mainland's continuing opening up to integrate with global financial markets

(a) Hong Kong will continue to be an attractive location for Mainland companies to raise capital, and for Mainland investors to invest their savings overseas. Hong Kong will also be the springboard for Mainland financial firms to operate, gain experience and expand outside China.

(b) The Mainland is now embarking on the internationalisation of the RMB and has chosen Hong Kong as the offshore centre for RMB. This brings exciting opportunities and challenges for Hong Kong. The Commission will work with the Mainland authorities and other regulators in Hong Kong to make this a success.

(c) The Commission will continue to facilitate market development and maintain a robust regulatory framework for Hong Kong to remain an attractive international financial centre. It is therefore imperative for the Commission to be sufficiently resourced in order to proactively respond to the immediate and future regulatory challenges.

1.6 The Commission has also identified a number of areas where there is a clear case for expanding its staffing levels. These include:

1.6.1 Emerging staff feedback indicates there are significant concerns regarding excessive work levels across the Commission;

1.6.2 Extra resources are required to support Intermediaries Supervision (IS)'s delivery capability and supervisory framework; and

1.6.3 The requirement of expanding certain functions in the Commission's management structure.

1.7 To reduce the Commission's reliance on external recruits, the Commission started a few years ago to reshape the staffing structure of the Commission as part of the long-term strategy and enhance our talent pipeline by offering internships to both local and overseas graduates. To this end,

1.7.1 We have successfully recruited a total of 30 graduates in the last two years and we propose to continue the initiative in 2011/12.

1.7.2 We have been reshaping the staff structure by increasing the percentage of staff at a junior level. This has again been reflected in our proposed headcount increases this year where 26% (16/61) new headcount are at the junior professional level.

1.8 This long term manpower strategy will take several years to achieve, but we intend to achieve our goal by ensuring that each year we recruit an increased percentage of junior staff.

1.9 A failure to proactively mitigate the risk of losing our experienced junior and middle managers could have a significant impact on the delivery capacity of the Commission. With the full support of the Executive Committee and the Remuneration Committee, we included a provision of 0.5% of payroll costs within the 2010/11 budget, as a strategic adjustment. We have, however, only achieved incremental success so far in our attempt to narrow the pay gap of managers in the high turnover grades.

1.10 A bigger provision for strategic pay increase (3.2% of the payroll costs) is therefore proposed to be included in this budget to mitigate high turnover of our middle managers and to enhance our ability to retain the right people in a buoyant market. Resolution of this issue is viewed as strategically important and in past years the Remuneration Committee has instructed that we should address this by having a 'top up' provision in each year's budget so the existing pay gaps can be gradually closed.

1.11 Our budget includes proposals to expand our capacity to better meet the regulatory and supervisory challenges are explained in more detail in section 3.

1.12 The government's three-month public consultation on the proposed establishment of an Investor Education Council (IEC) and a Financial Dispute Resolution Centre (FDRC) closed on 8 May 2010. The Government has released the consultation conclusions on 13 December 2010.

1.13 In respect of the setting up of the IEC, the Government plans to submit the proposed legislative amendments to Securities and Futures Ordinance (SFO) to the Legislative Council in 1st half of year 2011. The Commission is expected to set up IEC immediately after the passage of the SFO amendments. For the purpose of the budget, we assumed that IEC will start operating in Q4 2011, and included half-year estimates for IEC's operations in the Commission's budget. In addition, we have also provided for funding of certain preparatory works which are required for the establishment of IEC, e.g. conducting a benchmarking survey to establish the levels of financial capability of

Hong Kong people, revamping the Commission's investor portal, to cater for IEC's wider ambit (see para 4.2.7(b) and 4.3.3).

1.14 The FDRC is expected to come into operation in 2012. It is the proposal for the Government, together with the Hong Kong Monetary Authority and the Commission, to provide the set-up costs and operation costs of FDRC in the first three years. Appropriate provisions have been made in the Commission's budget based on these assumptions (see para 4.3.4).

2. Executive summary

2.1 Set out below is a summary of the Commission's forecast for 2010/11 and proposed budget for 2011/12. This summary is intended to give an overview of the key factors influencing the Commission's forecast for 2010/11 and budget for 2011/12. For more detailed explanations reference should be made to sections 3 and 4 of this budget book.

	2011/12	2010/11		Variance			
	Proposed Budget	Forecast	Approved Budget	vs. forecast		vs. budget	
	(a)	(b)	(c)	d = (a-b)	(d/b)	e = (a-c)	(e/c)
	HK$'m	HK$'m	HK$'m	HK$'m	%	HK$'m	%
Income	**1,644.24**	1,608.29	1,662.77	35.95	2.2%	(18.53)	(1.1%)
Expenditure							
- Operating expenditure	**1,004.18**	876.31	890.75	127.87	14.6%	113.43	12.7%
- Funding to external parties	**51.00**	4.59	4.59	46.41	1011.1%	46.41	1011.1%
Total Expenditure	**1,055.18**	880.90	895.34	174.28	19.8%	159.84	17.9%
Surplus for the year	**589.06**	727.39	767.43	(138.33)	(19.0%)	(178.37)	(23.2%)
Reserves brought forward	**6,749.63**	6,022.24	5,948.12	727.39	12.1%	801.51	13.5%
Reserves carried forward	**7,338.69**	6,749.63	6,715.55	589.06	8.7%	623.14	9.3%
Capital Expenditure	**58.12**	43.74	44.18	14.38	32.9%	13.94	31.6%
Headcount	**648**	587	587	61	10.4%	61	10.4%

2.2 Income

2.2.1 2010/11 income is forecast to be $1,608.29 million. This is 3.3% below budget due to lower than budgeted market turnover and the lower than expected fees and charges income.

2.2.2 For 2011/12 we project that income will increase slightly by $35.95 million (2.2%) over the forecast primarily as a result of the recognition in 2011/12 of the unamortised portion of licensing annual fees received in 2010/11 (see para 4.1.3(b)).

2.3 Expenditure

Changes in budgeted expenditure levels are explained in detail within the body of this budget book. However, the following table highlights the key areas which contribute to the increase in budgeted expenditure for 2011/12.

	2011/12	2010/11		Variance			
	Proposed Budget	Forecast	Approved Budget	vs. forecast		vs. budget	
	(a)	(b)	(c)	d = (a-b)	(d/b)	e = (a-c)	(e/c)
	HK$'m	HK$'m	HK$'m	HK$'m	%	HK$'m	%
Staff cost	**728.00**	619.86	633.83	108.14	17.5%	94.17	14.9%
Premises	**92.42**	90.26	90.00	2.16	2.4%	2.42	2.7%
Information & systems	**32.19**	31.28	31.78	0.91	2.9%	0.41	1.3%
Professional & others	**56.93**	44.19	47.80	12.74	28.8%	9.13	19.1%
Internship programme	**8.15**	6.21	4.65	1.94	31.2%	3.50	75.3%
Depreciation	**51.00**	47.00	45.00	4.00	8.5%	6.00	13.3%
Funding to external parties	**51.00**	4.59	4.59	46.41	1011.1%	46.41	1011.1%
Other operating costs	**35.49**	37.51	37.69	(2.02)	(5.4%)	(2.20)	(5.8%)
Total Expenditure	**1,055.18**	880.90	895.34	174.28	19.8%	159.84	17.9%

2.3.1 2010/11 expenditure is forecast to be $14.44 million (1.6%) below approved budget. Savings in staff cost (see para 4.2.2 (a)) and professional and others expenses (see para 4.2.6 (a)) are partially offset by the increase in depreciation charges (see para 4.2.10(a)).

2.3.2 Total expenditure for 2011/12 is expected to increase by $174.28 million (19.8%) over 2010/11 forecast. This increase is substantially driven by increases in personnel costs. We propose the addition of 61 new positions in 2011/12 to cope with increased work load driven by challenges arising from regulatory reform and market development. Details of these increases are set out within the body of this report (section 3). Secondly, we have budgeted an average 5% salary adjustment for our staff. This provision is based on information available to us at this time regarding remuneration in comparable organizations. As previously recommended by the Remuneration Committee, a further 3.2% strategic adjustment has been made to correct the historic distortion that has arisen in some of our middle and junior pay bands. However, final decisions regarding the level of pay awards to each grade of staff will not be made until early 2011 when our regular pay survey data are available. The Executive will then determine the specific pay policy and present this to the Remuneration Committee for discussion and to the Commission for approval.

2.3.3 Premises expenses for 2011/12 are expected to increase by $2.16 million (2.4%) due to projected increase in rates, management fees and reinstatement costs.

2.3.4 Our professional costs for 2010/11 are lower than the approved budget by $3.61 million. The legal costs recovered are partially offset by the increase in external professional services required by Enforcement investigation (see para 4.2.6). As we do not expect any significant recovery in legal costs in 2011/12, professional and others expenses are consequently increased as compared with the forecast.

2.3.5 For budget purposes, we have included a provision of $45 million for funding to the Investor Education Council (IEC) and Financial Disputes Resolution Centre (FDRC) in the 2011/12 budget, on the assumption that both entities will be operative in the latter part of the year (see para 4.2.7(b), 4.3.3 and 4.3.4). We have also provided a funding of $1.2 million to the Hong Kong Securities Institute for the development of licensing examination for Type 10 regulated activity (providing credit rating services).

2.4 Operating result

2.4.1 We forecast a surplus of $727.39 million at the end of 2010/11.

2.4.2 A surplus of approximately $589.06 million is expected in 2011/12 leaving our overall reserves at $7.34 billion at the end of that financial year, approximately 7 times our annual costs after depreciation.

Assumptions

2.5 Investor levy rates

2.5.1 The levy rates will remain unchanged for the year 2011/12, i.e.

(a) Investor Levy Rate - Securities, at 0.003% and

(b) Investor Levy Rate - Future/Options contracts, at $0.6/$0.12 per contract.

2.6 Market turnover

2.6.1 Equity market

(a) Based on the SFC Research Department's latest forecast, using a basis consistent with prior years, the average securities market turnover is assumed to be $79 billion/day for the remainder of 2010/11 and $81 billion/day for 2011/12.

2.6.2 Futures and Options market

(a) Based on transaction volume for the past six month (Apr – Sep 10), futures/options market turnover is assumed to be an average of 182,000 contracts per day for the rest of 2010/11. For forecasting purposes we have assumed that volume will increase in line with estimated increase in the securities market turnover. On this basis, futures/options market turnover is assumed to be an average 205,000 contracts per day in 2011/12.

2.7 Fees and charges

2.7.1 The rates of fees and charges are assumed to remain unchanged for 2011/12.

2.8 Rate of return

2.8.1 The average return on investment of our reserve funds is assumed to be 2% p.a. for the year 2011/12.

2.9 Remuneration adjustment

2.9.1 A provision of 5% of personnel costs has been included on the assumption that there will be a salary adjustment for staff. (see also 4.2.2 (b)(iii)).

2.10 Inflation

2.10.1 Where an estimate of general price level increases is required we have assumed 3%. This is used where we do not have specific data and/or quotes on which to estimate our future costs.

2.11 Capital expenditure

2.11.1 Capital expenditure is budgeted based on the level of expenditure which will be ‘committed to’ within a financial year. However, actual expenditure incurred will differ from this and the approved estimates of capital expenditure for different capital projects will, as previously, be carried forward until the completion of the projects.

3. Manpower plan

3.1 The manpower plan for 2011/12 is based on our assessment of the staff strength required to discharge the Commission's regulatory functions as they are known at this time, exclusive of additional resources which are contingent upon the introduction of legislation like PSI. Having critically reviewed our manpower requirements, a net increase in approved headcount of 61 full time positions (10.4%) has been included in the 2011/12 budget.

3.2 Our proposed manpower plan is outlined below:

Division	**Headcount**				
	Approved 2010/11	Proposed 2011/12	Position upgrades	Net Change	Para /ref
CEO's Office & Commission Secretariat (CEOO)	18	20	1	+2	3.3
Corporate Finance	54	56	2	+2	3.4
Enforcement	125	140	1	+15	3.5
Intermediaries Supervision	104	116		+12	3.6
Licensing	60	66		+6	3.7
Legal Services	24	26	1	+2	3.8
Policy, China & Investment Products (PCIP)	75	89	3	+14	3.9
Supervision of Markets	29	30	2	+1	3.10
Corporate Affairs	98	105	6	+7	3.11
TOTAL	**587** Note 1	**648**	**16** Note 2	**61**	

Note 1 : Including the upgrade of a Director to Senior Director as approved by the Board to recruit a Senior Director, Corporate Affairs to replace the former Chief Operating Officer.

Including the transfer of a Manager from Supervision of Markets Division to CEO's Office & Commission Secretariat

Note 2: The 16 position upgrades in 2011/12 is expected to cost less than 1% of the total staff cost increase over the 2010/11 forecast.

3.3 To enable the Commission to monitor risk and implement corporate strategy more effectively, a centralised strategy and risk team and an international team in CEOO to work in tandem with the operating divisions are considered necessary.

In the Strategy Planning and Risk area, the CEO and the Executive Committee Members are currently the key drivers in formulating Commission-wide strategy. In order to more effectively coordinate the Commission's strategy and risk monitoring work being performed at divisional level, a centralised strategy and risk function, which consists a Director and supported by a Senior Manager and a Manager, is proposed to oversee Commission-wide strategic planning and risk management.

With regard to International Affairs, international work is now part of the mandate of the Secretariat which is headed by a Director and supported by a Senior Manager and a Manager. The surge of activities arising from international regulatory reforms which emanated from the global financial crisis, however, means that it is no longer sustainable for the Secretariat to handle the increasing volume of international work on top of its operational responsibilities which include managing cross-divisional consultations with the public and handling increased enquiries from the Government, legislators, the Legco Subcommittee and the Ombudsman. The proposed set up of a dedicated international team, consisting of a Director, a Senior Manager and a Manager, to centralize and manage international work going forward is considered necessary.

In addition, one headcount at junior level (Secretary) is proposed to be created to support the media team, which consists of an Associate Director and 3 Managers, when the communication function is centralised.

Instead of creating seven new positions in 2011/12 (including 2 Directors, 2 Senior Managers, 2 Managers and 1 Secretary), it is proposed to re-deploy five existing headcount originally created for the Decision Making Panel (3 Directors and 2 Secretaries) for this purpose. Consequentially, only two new headcount are proposed to be added to the CEO's Office in the 2011/12 budget.

In addition, one executive position upgrade in the Secretariat is recommended to reflect the increasingly complex nature of the work.

3.4 Two additional headcount at executive level are proposed for the Corporate Finance Division (CFD) to support investigation of takeover cases and the increasingly heavy IPO work. It is expected that there will be voluminous applications and phone calls for consultations.

It is worth noting that three headcount are not included in the budget calculation for 2011/12 as they are contingent upon the introduction of legislation governing disclosure of Price Sensitive Information (PSI). These headcount are proposed for the formation of a new PSI operation team to handle consultations and waiver applications. It is expected that there will be voluminous applications and phone calls for consultations and these would require the team to be staffed by 3 senior executives closer to the time of the introduction of PSI. Failure in this area may affect Enforcement Division's work in subsequent breaches.

In addition, two upgrades in CFD are required to reflect the expansion of job scope and the increased complexity of work in the Division.

3.5 A total of fifteen new headcount, including six executives and nine non-executives, are proposed by the Enforcement Division. Substantial increase in the number of investigations over the past 12 months requires the Enforcement Division to add a new investigation team of twelve staff to cope with both new cases and a sufficiently wide portfolio of current ones.

A further three positions are proposed by the Enforcement Division to support the Discipline Team, in view of the increasing number of investigation cases which require the Discipline Team to provide strategic and legal advice and to prepare potential disciplinary actions after reviewing and assessing relevant evidence.

In addition, one upgrade is required to reflect the expansion of job scope in Discipline Team to take up leadership responsibilities.

3.6 Twelve additional headcount are proposed for the Intermediaries Supervision Department in 2011/12 to increase the Department's capacity in light of increasing challenges for regulating and supervising licensed corporations. These additional resources will be utilized to achieve the following key objectives:

- To conduct more thematic reviews on topical regulatory issues arising from emerging market trends or issues;
- To inspect high risk or impact firms in a more frequent manner, focusing on different risk areas; and
- To conduct more inspections focusing on conduct issues.

The creation of more headcount in subsequent years is anticipated in order to better fulfill all of the above objectives.

3.7 Six new positions are proposed for Licensing Department to handle a significant growth in the number of applications and the extra workload to be generated by licensing of credit rating agencies, commencing in the first half of 2011. Statistics showed that the Licensing Department will receive an almost 35% more applications in 2010 than it received in 2009 on an annualized basis. The anticipated growth in the number of applications at the current rate requires the Licensing Department to recruit more staff next year to handle and process the high volume of applications, failing which the Commission will not be able to meet its performance pledges.

3.8 Two new executive positions are proposed for Legal Services Division to cope with the increasing workload in civil litigation and to assist in-house advisory work generating by other Divisions/Departments. The Legal Services Division expects these new executive positions can be leveraged to enhance their technical excellence (particularly civil) on law drafting, advisory and litigation work. One non-executive upgrade is required to reflect the expansion of job scope in this administrative position.

3.9 A total of fourteen additional permanent headcount are proposed to expand PCIP's capacity and to acquire the necessary expertise to meet its operational needs. These additional headcount (including 8 executives for Product teams, 3 executives for Policy Team and 3 general grade staff) are proposed to address the challenges posted by complex products and RMB-denominated investment products, and to support the policy initiatives for developing Hong Kong into a premier asset management centre. Three upgrades are required to reflect the expansion of job scope in managing challenging workload in the investment products department.

3.10 One new position is proposed for the Supervision of Markets Division to cope with the increasing workload on regulatory reforms and related legislative amendments. This new headcount is expected to proactively do more policy work to better prepare the Commission to manage any future potential financial crisis. Two upgrades, one in executive and one in non-executive grade, are required to reflect the expansion of job scope in dealing with the exchange rules and legislative amendments in relation to the OTC derivatives regulation and also in monitoring the implementation of various regulatory reforms which are currently underway in the major markets.

3.11 One junior professional position and one support staff position are proposed by the External Relations Department to deal with an increased volume of translation workload and to handle a 30% increase in complaint volume. In addition, one upgrade is required to reflect the expansion of job scope in external survey planning work.

One executive position is proposed by the Human Resources Department to support the development and implementation of talent management next year. In addition, one upgrade is proposed in Human Resources Department to reflect the expansion of job scope in supporting new initiatives such as culture development and staff engagement.

One additional administrative position is proposed by the Finance and Administration Department to handle the increase in billing and cheques processing work. In addition, two non-executive upgrades are proposed to reflect the expansion of job scope in performing accounting duties and the supervisory role for clerical support staff.

Three new headcount are proposed by the Information Technology Department to allow the conversion of three existing contract staff to permanent staff. This is a move for the Commission to secure a smooth execution of the IT roadmap. In addition, two upgrades are required to reflect the expansion of job scope in leading and creating a standard for performing Business Process Management.

4. Income and expenditure

Summary of major budget items:-

	Para. Ref.	(A) Proposed Budget For Year 2011/12 HK$'000	(B) Forecast For Year 2010/11 HK$'000	(C) Approved Budget For Year 2010/11 HK$'000	(A)-(B) / (B) Proposed Budget Over/(under) Forecast %	(B)-(C) / (C) Forecast Over/(Under) Approved Budget %
INCOME						
Investor Levy	4.1.2					
Securities		1,205,280	1,242,000	1,284,640	-3.0%	-3.3%
Futures/Options Contracts		61,008	63,385	64,926	-3.8%	-2.4%
Fees & Charges	4.1.3	242,800	170,000	191,600	42.8%	-11.3%
Investment Income	4.1.4	129,650	127,403	116,100	1.8%	9.7%
Other Income	4.1.5	5,500	5,500	5,500	0.0%	0.0%
Total		**1,644,238**	**1,608,288**	**1,662,766**	2.2%	-3.3%
OPERATING EXPENDITURE						
Premises	4.2.1	92,421	90,265	90,000	2.4%	0.3%
Staff cost	4.2.2	728,000	619,857	633,828	17.5%	-2.2%
Info. & Sys. Services	4.2.3	32,187	31,281	31,779	2.9%	-1.6%
General Office & Insurance	4.2.4	7,376	6,855	7,137	7.6%	-4.0%
Training & Development	4.2.5	8,400	7,640	7,600	10.0%	0.5%
Professional & Others	4.2.6	56,935	44,188	47,804	28.8%	-7.6%
External Relations	4.2.7	16,714	21,518	19,955	-22.3%	7.8%
Internship Programme	4.2.8	8,150	6,210	4,650	31.2%	33.5%
Contingency	4.2.9	3,000	1,500	3,000	100.0%	-50.0%
Depreciation	4.2.10	51,000	47,000	45,000	8.5%	4.4%
Total (1)		**1,004,183**	**876,314**	**890,753**	14.6%	-1.6%
FUNDING TO EXTERNAL PARTIES						
Funding to FRC	4.3.1	4,410	4,200	4,200	5.0%	0.0%
Funding to IASC Foundation	4.3.2	390	390	390	0.0%	0.0%
Funding to IEC	4.3.3	37,000	0	0	N/A	N/A
Funding to FDRC	4.3.4	8,000	0	0	N/A	N/A
Funding to HKSI	4.3.5	1,200	0	0	N/A	N/A
Total (2)		**51,000**	**4,590**	**4,590**	1011.1%	0.0%
TOTAL EXPENDITURE (1)+(2)		**1,055,183**	**880,904**	**895,343**	19.8%	-1.6%
CAPITAL EXPENDITURE						
Furniture & Fixtures		2,000	8,900	10,000	-77.5%	-11.0%
Office Equipment		13,070	16,510	14,275	-20.8%	15.7%
Computer Sys. Development		37,770	14,895	15,890	153.6%	-6.3%
Sub-total		52,840	40,305	40,165	31.1%	0.3%
Contingency		5,284	3,434	4,016	53.9%	-14.5%
Total	4.4.1-4.4.2	**58,124**	**43,739**	**44,181**	32.9%	-1.0%

4.1 Income

4.1.1 Annual grant from government

(a) 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." As in previous years, the Commission proposes that the Government does not request any appropriation from the Legislative Council for the financial year 2011/12. The Commission's decision is made without prejudice to the funding principles established when the Commission was formed, and has no implications for requests for appropriations in future years.

4.1.2 Investor levy

(a) The following turnover and levy rate assumptions have been used in preparing levy income estimates:

	2010/11			2011/12
	Budget	Apr-Sep (actual)	Oct-Mar (assumption)	Apr-Mar
Securities				
Daily turnover (billion/day)	$74.0	$65.7	$79.0	$81.0
Levy rate [Note 1]	0.003%	0.004%	0.003%	0.003%
Futures/Options Contracts				
Daily turnover (contracts)	187,000	182,000	182,000	205,000
Levy rate [Note 1]	$0.6	$0.8	$0.6	$0.6

Note 1 The levy rates were reduced by 25% from 0.004% and $0.8/contract to 0.003% and $0.6/contract with effect from 1 October 2010.

(b) The 2010/11 Forecast of Investor Levy – Securities is lower than the Approved Budget by 3.3% ($42.64 million) and for Investor levy – Futures and Options by 2.4% ($1.54 million). These decreases reflect the lower market turnover in the first six months of 2010/11 compared to the estimates underlying the Approved Budget as noted above.

(c) The daily turnover assumption for the 2011/12 Proposed Budget is based on estimates made by our Research Department on a basis consistent with prior years. We project the average securities market turnover for 2011/12 will be 2.5% higher than the turnover assumed for the remainder of 2010/11.

(d) Despite the substantial reserves accumulated, we do not propose any reduction in levy rates on the ground that the levy rates were changed recently in October 2010 and it would not be economical to change the levy rates again in one year's time as the administrative costs for change in legislation and compliance are high.

4.1.3 Fees and charges

(a) The Forecast aggregate fees and charges income for 2010/11 is 11.3% ($21.6 million) lower than the Approved Budget. This decrease arises from the lower than expected licensing annual fees recognised in 2010/11.

(b) The 2011/12 Budget shows an increase in fee income of 42.8% against Forecast for 2010/11. This increase arises from the resumption of licensing annual fees in 2010/11 after the fee holiday granted in 2009/10. Due to the amortisation of licensing fees over the lifetime of the license period, the full effect of the resumption on recorded income will be reflected in 2011/12.

4.1.4 Investment income

(a) Investment income for 2010/11 is forecast to be $127.4 million, 9.7% higher than the Approved Budget as the investment advisory fees expected to be payable to external fund managers did not materialise. In the Budget, we assumed that the management of the reserves will be outsourced in 2010/11 at a cost of $7.5 million and the management costs had been deducted from the budget investment income. For the remainder of the year, the average return on dated securities and fixed deposits has been assumed to be 2% p.a.

(b) 2011/12 investment income is budgeted to be $129.65 million, 1.8% ($2.25 million) higher than the 2010/11 Forecast as the funds available for investment will increase over the year. The average rate of return for the year is assumed to be 2% p.a.

4.1.5 Other income

(a) Other income represents net income generated from FinNet, recoveries from investigation cases and sale of SFC publications.

4.2 Operating expenditure

4.2.1 Premises

(a) Forecast premises expenses for 2010/11 are expected to be slightly above the approved budget by $0.27 million (0.3%) due to higher demand in office security and crowd control services.

(b) Expenses for 2011/12 are budgeted to be 2.4% ($2.16 million) higher than 2010/11 Forecast mainly due to higher rates, management fees and reinstatement costs provided in the Budget.

4.2.2 Staff cost

(a) The overall staff cost for 2010/11 are forecast to be lower than the 2010/11 budget by 2.2% ($13.97 million) mainly due to the lag time experienced in filling management vacancies and a number of positions being under-filled by lower grades.

(b) The projected headcount at 31 March 2012 is 648, a net increase of 61 (10.4%) over the approved headcount included in the 2010/11 budget. Please see paras. 3.1 – 3.11 for detailed explanations of this increase in headcount. The projected staff cost for 2011/12 are 17.5% ($108.14 million) higher than the 2010/11 Forecast and 14.9% ($94.17 million) higher than the 2010/11 budget.

A breakdown of the underlying sources of this overall increase is set out below:

Source of increase in staff cost	HK$'m	Increase over forecast	% impact	*Note*
New headcount	47.5	7.7%	44.0%	*i*
Promotion	4.7	0.8%	4.3%	*ii*
Annual pay review	30.9	5.0%	28.5%	*iii*
Strategic adjustment	17.7	2.9%	16.3%	*iv*
Retirement benefits	5.5	0.9%	5.1%	*v*
Insurance premium increase	0.9	0.1%	0.9%	*vi*
Recruitment	0.9	0.1%	0.9%	*vii*
Total increase over forecast	108.1	17.5%	100.0%	

(i) 33 executive positions and 28 non-executive positions are proposed to ensure that the Commission has adequate resources to deliver its priorities in 2011/12, in particular in the areas of regulatory reforms, enhanced enforcement and supervision capabilities and organizational improvements. To ensure that we can recruit capable talent from the recovering labor market, the market pay data in 2009 has been aged by 4% for budget calculation.

(ii) Changes in remuneration levels during the year arising from salary adjustments in April and October 2010, as well as providing career progression for deserving staff of an expanded workforce in 2011/12 are the key factors contributing to the slight increases in the annual promotion cost.

(iii) The 2011/12 budget includes the provision for an average 5% pay increase for Commission staff. This is based on market information from external parties including pay consultants and professional associations. Detailed proposals for the actual pay increase between grades will be formulated in Q1, 2011. These proposals will be presented to the Remuneration Committee for endorsement and subsequently to the Commission for final approval. The allocations between grades will be determined based on an analysis of external data and in particular pay level surveys by two external consultants (Hay and McLagan), which are only received after approval of this budget by the Commission.

Another source of increase is the provision for the mid-term reviews for three of our Executive Directors.

(iv) A "strategic adjustment" provision of $17.7 million (3.2% of payroll costs) has been made to narrow the pay gaps of staff in high turnover mid-level pay bands that have fallen behind market norms, as well as those of high performing staff in other grades. This targeted annual 'top up' provision was agreed by the Remuneration Committee as a strategy to resolve historical pay anomalies over a period of several years. Although the Commission achieved incremental success through implementing the strategic pay increases in April and October this year, the resultant impact was not strong enough to close the identified gaps against the going market rates. Failure to address the pay issues in a buoyant market is expected to lead to even higher costs for the Commission to attract and retain a sufficient level of highly qualified staff to meet the needs of an expanding organization in the coming financial year.

(v) The growth in retirement benefit cost flows directly from increases in the underlying salary costs as well as the projected increase in headcount in 2011/12.

(vi) The higher insurance expenses for 2011/12 reflect increases in overall payroll as a result of the proposed increases in salary and headcount. Part of this increase in costs has been offset by a slight downward adjustment of the premium rate for medical benefit insurance that the Commission successfully negotiated with the insurance provider last year due to our satisfactory claims history.

(vii) Additional recruitment expenses have been provided to cover the increased expenses due to expected headcount changes and potential search fees for senior staff in 2011/12.

4.2.3 Information and systems services

(a) The Information and Systems Services expenses forecast for 2010/11 are on budget.

(b) For 2011/12, we project a 2.9% ($0.91 million) increase due to additional maintenance costs for new software and hardware and increases in subscriptions for market data to support enforcement and supervision activities. Such increases are partially offset by the one-off expenses incurred for the information security policy project carried out in 2010/11.

4.2.4 General office and insurance

(a) General Office and Insurance expenses for 2010/11 are on budget.

(b) Expenses for 2011/12 are expected to be higher than 2010/11 Forecast by 7.6% ($0.52 million) due to higher printing and office services expenses.

4.2.5 Training and development

(a) Forecast training related expenses for 2010/11 are on budget.

(b) Training expenses for 2011/12 are 10% ($0.76 million) higher than forecast due to the projected increase in headcount. Training for 2011/12 will continue to focus on executive development and talent management.

4.2.6 Professional and others

(a) Professional and Others expenses for 2010/11 are 7.6% ($3.62 million) below the approved budget. Savings in legal fees arising from legal costs recovered are partially offset by the increase in external professional services as a result of the increase in the number of investigation cases and demand for market experts and computer forensics services.

(b) Professional and Others expenses for 2011/12 are expected to increase by 28.9% ($12.75 million) as we do not expect any significant recovery of legal costs. The demand for external expert services will remain high, especially in the areas of investigation, supervision of intermediaries and new products (see also para 2.3.4).

4.2.7 External relations

(a) Forecast External Relations expenses for 2010/11 are forecast to be higher than budget by 7.8% ($1.56 million) due to more overseas business trips taken to enhance the Mainland/international profile of the Commission, promote collaboration and keep abreast of international development of securities market and regulatory trends.

(b) The Government has issued a Consultation Paper on the proposed establishment of an Investor Education Council (IEC) in February 2010. The IEC will holistically oversee the needs of investor education and delivery of related initiatives. For budget purpose, we assume that the IEC will start its operation in October 2011 and part of the investor education initiatives undertaken by the Commission will then be transferred to the IEC (see also para 4.3.3). As a result, we have only included in this budget investor education expenses for the first six months of 2011/12. The investor education expenses for the second half of 2011/12 are reflected in the funding to IEC. We have also increased the overseas travelling budget by 23.7% ($1.8 million) as we will continue to focus on international cooperation and global market reform. These have led to a net 22.3% ($4.8 million) reduction in 2011/12 Budget over the Forecast.

4.2.8 Internship programme

(a) This represents the salary cost for hiring university graduates in support of the Government's internship for university graduate programme. We expect that more resources will be required to provide more competitive packages to tap and retain the capable workforce.

4.2.9 Contingency

(a) A contingency of $1.5 million is provided for the remainder of 2010/11 and $3 million provided for 2011/12 to cover unforeseen expenses arising from changes in the operating environment or unforeseen special requirements. This is consistent with prior years' practice.

4.2.10 Depreciation

(a) Forecast depreciation expense for 2010/11 is expected to be 4.4% ($2 million) above budget because of higher-than-expected capital expenditure actually incurred in current year.

(b) We expect that the depreciation expenses for 2011/12 will be 8.5% ($4 million) higher than 2010/11 Forecast due to increases in capital expenditure incurred in 2011/12.

4.3 Funding to external parties

4.3.1 To continue our support for the work of the Financial Reporting Council, the Commission will provide annual funding of $4.4 million in 2011/12.

4.3.2 To continue our support for the work of the International Accounting Standards Committee Foundation the Commission will again provide funding of US$50,000.

4.3.3 We have provided $37 million for funding the Investor Education Council (IEC) on the assumption that the IEC will start its operation from October 2011. $10 million is provided for its start up costs and $27 million for the operating costs for the half year. We have not taken into account the staff costs for those staff currently performing investor education function in the Commission. These staff will be transferred to the IEC when it commences operation and the estimated staff cost for a 6-month period will be around $3 million.

4.3.4 Assuming that the Financial Dispute Resolution Centre (FDRC) will start its operation in January 2012 and the Commission will share 1/4 of its start up and annual operating costs, we have provided $8 million for the funding.

4.3.5 We have provided $1.2 million in 2011/12 to support the Hong Kong Securities Institute in designing the curriculum and examination papers for the new regulatory regime for credit rating agencies, which is expected to commence in the first half of 2011.

4.4 Capital expenditure commitment

4.4.1 The total capital expenditure forecast for 2010/11 has been reduced from $44.18 million to $43.74 million principally as a result of the reduction of the contingency provision by $0.58 million.

4.4.2 The total capital expenditure budget commitment for 2011/12 is $58.12 million, 32.9% ($14.39 million) higher than 2010/11 Forecast. This increase is the combined effect of lower office furniture and fixtures costs mainly attributable to the completion of the renovation project in 2010/11 and the higher computer systems development costs. The planned capital expenditure commitment comprises the following:-

Capital expenditure	Amount HK$ m	*Note*
Office furniture & fixtures	2.00	*i*
Office equipment	13.07	*ii*
Computer systems development	37.77	*iii*
Contingency (10%)	5.28	*iv*
Total	58.12	

Notes :-

(i) replacement of obsolete office furniture and fixtures due to normal wear and tear.

(ii) for office equipment:

- $1.5 million for replacement of obsolete office equipment due to normal wear and tear; and
- $11.57 million for investment in storage technology and data base capacity in response to increased market activities plus costs relating to the normal replacement of obsolete servers and computer equipment for the additional headcount.

(iii) for “front-end” technology to upgrade our market surveillance capabilities, improve access and exchange of information between stakeholders and the Commission, integration of backend licensing system with front end e-portal and enhance various IT systems including investigation management system and market surveillance system etc.

(iv) a contingency of $5.28 million, which, as in prior years, is set at 10% of the budgeted capital expenditure.

5. Projected income and expenditure statement

	Proposed Budget 2011/2012	Forecast 2010/2011	Change over/(under) Forecast 2010/2011	
	HK$	HK$	HK$	%
INCOME				
Investor Levy - Securities	1,205,280,000	1,242,000,000	(36,720,000)	-2.96%
Investor Levy - Futures/Options Contracts	61,008,000	63,385,000	(2,377,000)	-3.75%
Fees & Charges	242,800,000	170,000,000	72,800,000	42.82%
Investment Income	129,650,000	127,403,000	2,247,000	1.76%
Other Income	5,500,000	5,500,000	-	0.00%
Total Income	1,644,238,000	1,608,288,000	35,950,000	2.24%
OPERATING EXPENDITURE				
Premises	92,421,000	90,265,000	2,156,000	2.39%
Staff cost	728,000,000	619,857,000	108,143,000	17.45%
Information & Systems Services	32,187,000	31,281,000	906,000	2.90%
General Office & Insurance	7,376,000	6,855,000	521,000	7.60%
Training & Development	8,400,000	7,640,000	760,000	9.95%
Professional & Others	56,935,000	44,188,000	12,747,000	28.85%
External Relations	16,714,000	21,518,000	(4,804,000)	-22.33%
Internship Programme	8,150,000	6,210,000	1,940,000	31.24%
	950,183,000	827,814,000	122,369,000	14.78%
Contingency	3,000,000	1,500,000	1,500,000	100.00%
Depreciation	51,000,000	47,000,000	4,000,000	8.51%
Total operating expenditure (1)	1,004,183,000	876,314,000	127,869,000	14.59%
FUNDING TO EXTERNAL PARTIES (2)	51,000,000	4,590,000	46,410,000	1011.11%
Total expenditure (1) + (2)	1,055,183,000	880,904,000	174,279,000	19.78%
RESULT FOR THE YEAR	589,055,000	727,384,000	(138,329,000)	-19.02%
BEGINNING RESERVES	6,749,623,968	6,022,239,968	727,384,000	12.08%
ENDING RESERVES	7,338,678,968	6,749,623,968	589,055,000	8.73%