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Panel on Financial Affairs
Meeting on 5 February 2018

Updated background brief
on the annual budgets of the Securities and Futures Commission

Purpose

This paper sets out background information on the arrangements for funding the operation of the Securities and Futures Commission ("SFC") and the scrutiny of SFC's annual estimates. The paper also summarizes the major concerns and views expressed by members when the Panel on Financial Affairs ("FA Panel") discussed SFC's proposed budgets for the five financial years from 2013-2014 to 2017-2018.

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 in 1989 as the statutory regulator of the securities and futures market. In 2002, the Legislative Council ("LegCo") enacted the Securities and Futures Ordinance (Cap. 571) ("SFO") which consolidated and modernized 10 ordinances including Securities and Futures Commission Ordinance regulating the securities and futures market. SFO came into operation on 1 April 2003.

3. The regulatory objectives of SFC as prescribed in section 4 of SFO are to:

- (a) maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry;
- (b) promote understanding by the public of financial services including the operation and functioning of the securities and futures industry;

- (c) provide protection for members of the public investing in or holding financial products;
- (d) minimize crime and misconduct in the securities and futures industry;
- (e) reduce systemic risks in the securities and futures industry; and
- (f) assist the Financial Secretary ("FS") in maintaining the financial stability of Hong Kong by taking appropriate steps in relation to the securities and futures industry.

4. Under SFO, the Board of Directors of SFC shall make up of no fewer than eight members and the majority of them must be non-executive directors.¹ All directors of the Board are appointed by the Chief Executive ("CE") or FS with the delegated authority of CE. The Executive Committee performs administrative, financial and management functions as delegated by the Board of Directors. As at 31 March 2017, the actual staff strength of SFC was 867,² consisting of 677 professional staff and 190 support staff. The organizational structure of SFC as at March 2017 is shown in **Appendix I**.

Financial arrangements

5. Section 14 of SFO provides that the Government shall provide funding to SFC as appropriated by LegCo. In practice, SFC has been self-funded through transaction levies from investors and fees and charges from market intermediaries since 1993-1994, and thus has not requested for appropriation from LegCo since then.

6. Under section 13(2) of SFO, SFC is required to submit, not later than 31 December of each year, the estimates of its income and expenditure (i.e. budget) for the next financial year³ to CE for approval. The approval authority was delegated to FS in 1995. Under section 13(3) of SFO, FS shall cause the budget as approved pursuant to section 13(2) to be laid on the table of LegCo. In addition, under section 15(3) of SFO, SFC shall send a report on its activities conducted during the previous financial year (i.e. the annual report) to FS, who shall cause a copy to be laid on the table of LegCo. In each of the past five years, the approved budget and annual report of SFC were respectively

¹ Section 1 of Part 1 of Schedule 2 to the Securities and Futures Ordinance ("SFO") provides for the composition of the Board of Directors.

² The budgeted headcount in the 2016-2017 budget of the Securities and Futures Commission ("SFC") was 917.

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

tabled at a Council meeting in May and June.⁴ It is a practice for SFC and the Government to brief FA Panel in the month of February or March of each year on SFC's proposed budget and major initiatives proposed for the next financial year.

7. According to section 396 of SFO, if SFC's reserves, after deducting depreciation and all provisions are more than twice its estimated operating expenses for a financial year ("reserves threshold") and SFC has no outstanding borrowings, SFC may consult FS with a view to recommending to CE in Council that the rate of a levy be reduced under section 394 of SFO.⁵

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

8. The major views and concerns expressed by members when FA Panel discussed the proposed budgets of SFC for the financial years from 2013-2014 to 2017-2018 at the meetings on 4 February 2013, 7 February 2014, 2 February 2015, 15 February 2016 and 6 February 2017 are summarized in the ensuing paragraphs.

Reserves, levies and licensing fees

9. During the discussion on SFC's proposed budgets for the past few financial years, members noted that SFC continuously hold huge reserves which far exceeded the reserves threshold as specified in section 396 of SFO, and called on SFC to consider waiving or reducing the levies and fees charged on market participants.

10. Regarding transaction levies, SFC advised that there was no absolute requirement that the levy rates must be adjusted when the reserves had exceeded the reserves threshold, and changes to the rates would be made having regard to the relevant circumstances. SFC had effected a levy reduction of 20% in December 2006 and a further reduction of 25% in October 2010.⁶ As for

⁴ SFC's approved budgets were tabled at the Council meetings on 22 May 2013, 28 May 2014, 27 May 2015, 4 May 2016 and 17 May 2017. SFC's annual reports were tabled at the Council meetings on 26 June 2013, 25 June 2014, 17 June 2015, 22 June 2016 and 14 June 2017.

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

⁶ The new levy rates took effect on 1 October 2010 after the enactment of the Securities and Futures (Levy) (Amendment) Order 2010.

licensing fees,⁷ SFC advised that the principle of full cost recovery was adopted. It had offered a one-year waiver of the annual licensing fees with effect from 1 April 2009. Another two-year annual licensing fees holiday was provided from 1 April 2012 to 31 March 2014.

11. During the discussion of SFC's proposed budget for 2013-2014 at the FA Panel meeting on 4 February 2013, noting that SFC continuously hold huge reserves which far exceeded the reserves threshold as specified in section 396 of SFO, members passed a motion demanding SFC to lower its levies. Members were of the view that the licensing fee waiver only benefited licensed intermediaries, and SFC should not use the fee waiver as a justification for not considering a reduction on the levy rates, which were paid by investors. There were also views that a levy reduction would lower the investment cost for investors and thus enhance the business opportunities for securities firms, especially the small and medium-sized enterprises ("SMEs"). To address members' concern, SFC committed to conducting a further comprehensive review of its financial position towards the end of 2013, and undertook to review proposals for more direct financial contributions to help investors and intermediaries, including funding to the Investor Education Centre ("IEC") and the Hong Kong Securities and Investment Institute.

12. At the FA Panel meeting on 7 February 2014, members noted SFC's proposal in the proposed budget for 2014-2015 to reduce the levy rates by 10%⁸ and extend the annual licensing fee holiday for two years starting from 1 April 2014. While members welcomed SFC's proposals, some members considered that there was room for further reduction of the levy rates as SFC's projection of the average daily securities market turnover was over-conservative. They urged SFC to continue conducting annual review of the levy rates, and cease the collection of levy when its reserves reached three times of SFC's annual operating expenditure. SFC responded that given the uncertainty in local market turnover level and the expected increase in regulatory costs, SFC would continue to incur an operating deficit in future years. To ensure the financial sustainability of SFC, the levy rates might need to be increased if SFC's reserves were depleted to below the reserves threshold.

13. At the FA Panel meeting on 2 February 2015, in view of the projected deficit of SFC in its proposed budget for 2015-2016, some members suggested that SFC should consider imposing a special levy on the northbound trading under the Shanghai-Hong Kong Stock Connect ("S-HK SC"). SFC advised that a substantial part of its reserves was built up in 2007-2008 because of the

⁷ Under section 395(1)(a) of SFO, CE in Council may, after consultation with SFC, make rules to require and provide for the payment of fees to SFC.

⁸ The new levy rates subsequently took effect on 1 November 2014 after the enactment of the Securities and Futures (Levy) (Amendment) Order 2014.

extraordinarily large market turnover at that time. Following past reductions in the levy rates, it was expected that SFC would continue to incur annual operating deficit of some \$400 million, unless there was substantial improvement in the market turnover in future, and SFC's reserves was expected to fall below the reserves threshold in five years' time. SFC did not have plans to impose a levy on the northbound trading under S-HK SC at the current stage, and would conduct a comprehensive review of S-HK SC six months after its implementation.

14. At the FA Panel meeting on 15 February 2016, members noted that SFC would extend the annual licensing fee holiday for one year from 1 April 2016 to 31 March 2017. At the FA Panel meeting on 5 February 2017, members suggested SFC should further extend the licensing fee holiday for two more years up to 2019-2020 in addition to the proposed one-year extension for 2017-2018.

Investment of the reserve fund

15. When FA Panel discussed SFC's proposed budgets for 2013-2014 and 2015-2016, members enquired about details of the investment income and management party for SFC's reserves.

16. SFC responded that it had a statutory obligation to adopt conservative and cautious strategies in investing its reserves, including capping investment in equity funds at 15% of the overall investment portfolio and putting the remaining 85% on fixed-income investments (e.g. bonds). SFC had set up an Investment Committee tasked with duties including exploring measures to improve the investment returns on its reserves. The Committee had appointed four fund managers to handle investments of SFC's reserves. The investment of SFC's reserves was managed by in-house staff in consultation with external investment advisers.

Human resources issues

17. During the discussions of SFC's proposed budgets for 2014-2015, 2015-2016, 2016-2017 and 2017-2018, members noted with concern SFC's increasing headcounts and staff cost as well as professional and other expenses. Some members asked whether SFC had plans to impose any cap on its headcounts and consider outsourcing some of its legal services.

18. SFC stressed that it had exercised prudence in the deployment of its reserves, and its budget was subject to monitoring by the public and LegCo. The substantial headcount increase over the years was necessary for proper regulation of the growing securities market, dealing with specific projects or challenges ahead (e.g. enhancing efficiency of SFC's enforcement process and

the supervision of the Hong Kong Stock Exchange, and its role in regulating listed companies). As regards the increase in professional and others expenses in the proposed budgets for 2016-2017 and 2017-2018, SFC explained that the professionals engaged by SFC were mainly legal and financial experts, especially those experienced in market regulation. The size of professional and legal fees reflected the high demand for such professional services in the market. SFC added that it was difficult to predict the future supply and costs of professional services. SFC had outsourced its legal services to law firms but experience had shown that it would be more efficient to have in-house capability than outsourcing. At the FA Panel meeting on 6 February 2017, SFC pointed out that its staff size was about right and would keep its annual headcount increase to under 3%. For the coming years, SFC envisaged that a similar rate of increase would be maintained barring unforeseen material changes in circumstances or an expanded remit.

Regulatory and enforcement work

Maintaining a level playing field for securities firms

19. When FA Panel discussed SFC's proposed budgets from 2013-2014 to 2016-2017, there were suggestions that SFC should strike a proper balance between market regulation and market development, and maintain a level playing field for securities firms of different sizes. Some members expressed concern that the substantial increase in SFC's manpower might imply tightening of supervision over intermediaries, thereby increasing the compliance burden on the securities industry. There was also concern about the fairness of the Securities and Futures (Financial Resources) Rules ("FRRs") which applied the same requirement to all firms regardless of their size. Members urged that SFC should conduct a review of FRRs for SME brokers taking into account their business viability. It was also suggested that SFC should deploy more resources to strengthen regulation of listed companies and expedite the process of applications for licences and authorizations.

20. SFC responded that the increase of headcount in the Intermediaries Division was to cope with the increased number of licensed intermediaries, and was not aimed at tightening regulation of small and medium-sized brokers. It was SFC's principle to exercise fairness in regulation that would be conducive to creating a level playing field for all intermediaries. The Intermediaries Division would be in charge of a comprehensive review of the regulatory requirements for intermediaries, including FRRs.

21. As regards compliance burden on the securities industry, SFC stressed that it had been adopting a fair and just regulatory approach and following international standards and practices at large for all regulated parties, irrespective of their scale of operation and having regard to their potential risks

to the market. In fact, SFC attached much importance to ensuring proper regulation of the large financial institutions due to the potentially greater systemic risks such institutions would pose on the market and the investing public. SFC understood that introducing new rules or requirements would inevitably increase compliance costs on the industry, but in practice there should be no conflict between investor protection measures and market development. SFC would continue to engage the industry when taking forward regulatory initiatives. Moreover, SFC had cut down the time for authorization of funds to six months and the average time taken for processing the applications was below that.

22. When FA Panel discussed SFC's proposed budgets for 2016-2017 and 2017-2018, members conveyed the industry's concerns regarding the implementation of the Client Agreement Requirements and the application of the Suitability Requirement under the Code of Conduct for Persons Licensed by or Registered with SFC ("the Code"). There was concern that the Suitability Requirement was unduly burdensome for small brokers, and SFC was urged to strike a proper balance between market regulation and market development.

23. SFC responded that the Suitability Requirement had been an existing requirement of the Code for many years and it had not been changed as a result of the Client Agreement Requirements. SFC was of the view that many existing client agreements were unfair to the clients, and decided to add a new clause in client agreements to the effect that if an intermediary solicited the sale of or recommended any financial product to a client, the financial product must be reasonably suitable for the client. If intermediaries were currently in compliance with the Suitability Requirement, they should not have any issue with the Client Agreement Requirements. The new clause in the client agreements would enable aggrieved clients to take legal action for breach of contract where there was a suitability failing causing loss. There would be a transitional period of 18 months before the new clause in client agreements would come into effect. In order to provide more clarity in advance of the coming into force of the new requirement, SFC issued a circular in December 2016. This made clear when the suitability requirements under the Code would be triggered. SFC had also issued a list of frequently asked questions on compliance with the suitability requirements, and would continue to liaise with the brokerage industry on the matter.

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

24. During the discussion of SFC's proposed budgets for 2014-2015 and 2016-2017, some members expressed concern about the unclear division of work between SFC and the Hong Kong Exchanges and Clearing Limited ("HKEX") in the regulation of listed companies, which might result in

regulatory overlaps or gaps. Some members also pointed out that the dual role of HKEX as a listed company and the frontline regulator of listing matters had given rise to conflict of interest. They asked whether SFC would consider taking over HKEX's role as the frontline regulator.

25. SFC responded that the regulatory functions of HKEX over listed companies were related to enforcement of the Listing Rules, whereas SFC regulated the securities and futures markets at large, including listed companies, in accordance with SFO. Under the current regulatory regime, the enforcement of the Listing Rules was overseen by the independent Listing Committee. SFC could have oversight of listing matters through the dual filing arrangements. The different perspectives in exercising regulatory oversight as well as the on-going coordination between SFC and HKEX would help ensure that there would be no regulatory overlaps/gaps between the two parties.

Access to confidential information on Mainland-incorporated entities

26. During the briefing on SFC's proposed budget for 2015-2016, members expressed concern about the difficulty for Hong Kong auditors to access confidential information held by Mainland auditors in respect of Mainland-incorporated entities when performing audits for their parent companies listed in Hong Kong. Members enquired if SFC would consider entering into a memorandum of understanding ("MOU") with the China Securities Regulatory Commission ("CSRC") to enable Hong Kong auditors, when undertaking audits for Mainland entities, to examine the audit working papers of Mainland auditors engaged by the Mainland entities concerned.

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

Backdoor listings of Mainland companies

28. When FA Panel discussed SFC's proposed budget for 2016-2017, some members expressed concern that the trend of "backdoor listings" of Mainland companies through purchasing shell companies listed in Hong Kong would have negative impact on the quality of the Hong Kong securities markets. They enquired about SFC's measures to strengthen regulation of backdoor listing in protecting investors.

29. SFC responded that they noted the concern about companies not qualified for listing entering the market through backdoor listings and reverse takeovers. Companies should be listed through a proper initial public offering process which included a mechanism to check the quality of the companies concerned for protection of investors. SFC and HKEX had been reviewing whether the current rules were sufficient to deal with backdoor listings, and whether there were any abuses.

Training initiatives and investor education

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

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

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

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

Office premises

34. During the discussions of SFC's proposed budgets for 2013-2014, 2014-2015, 2015-2016 and 2017-2018, some members suggested that SFC should consider leasing offices in districts with lower office rentals than those in Central. While members agreed that the offices of SFC should not be

luxurious, they had divergent views on whether SFC, being a regulatory body, should use its reserves to purchase its own offices. Noting that SFC had ring-fenced \$3,000 million in its reserves for possible acquisition of office premises in the proposed budget for 2016-2017, some members enquired whether SFC would need to seek the approval of LegCo for purchasing the office premises.

35. SFC advised in its proposed budget for 2016-2017 that purchasing its own property would eliminate the risk of future rental increases and could achieve annual savings in rental of about \$200 million. SFC's decision to acquire premises would be reflected in its budget, which required approval from FS under SFO. LegCo Members could express views on the matter when FA Panel was briefed on SFC's proposed budget. SFC assured members that SFC would carefully consider any acquisition of office premises bearing in mind cost-effectiveness. As regards the location of its office premises, SFC responded that in order to discharge its functions efficiently, SFC, as the regulatory body for the securities market, should be located in the central financial area. Nevertheless, bearing in mind cost effectiveness, SFC would consider all options including non-prime locations.

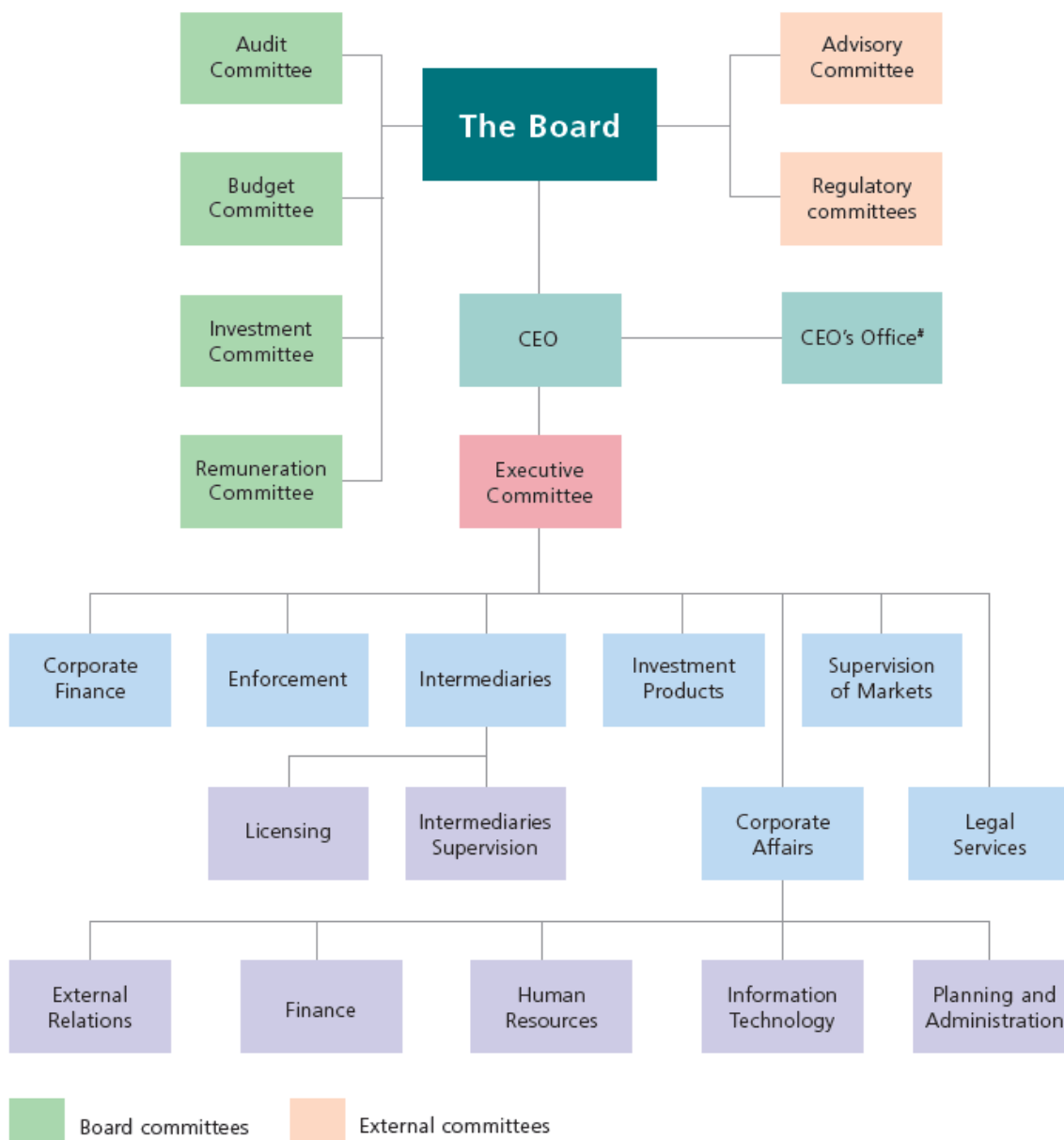
Recent development

36. SFC and the Government will brief FA Panel at the meeting on 5 February 2018 on SFC's proposed budget for the financial year 2018-2019.

Relevant papers

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

Organization structure of the Securities and Futures Commission



Source: SFC's Annual Report 2016-17

CEO's Office includes five units, namely the Commission Secretariat, International Affairs, Mainland Affairs, Press Office, and Risk and Strategy.

List of relevant papers

Date	Event	Papers/Minutes of meeting
4 February 2013	FA Panel discussed the proposed budget of SFC for 2013-2014	Administration's paper (LC Paper No. CB(1)484/12-13(07)) Minutes (LC Paper No. CB(1)930/12-13) Follow-up paper (LC Paper No. CB(1)684/12-13(02))
23 October 2013	The Legislative Council passed the motion on "Reviewing the functions of the Securities and Futures Commission"	Hansard Wording of the motion passed Progress report
7 February 2014	FA Panel discussed the proposed budget of SFC for 2014-2015	Administration's paper (LC Paper No. CB(1)804/13-14(04)) Minutes (LC Paper No. CB(1)1658/13-14) Follow-up paper (LC Paper No. CB(1)1039/13-14(02))
2 February 2015	FA Panel discussed the proposed budget of SFC for 2015-2016	Administration's paper (LC Paper No. CB(1)445/14-15(05)) Minutes (LC Paper No. CB(1)781/14-15) Follow-up paper (LC Paper No. CB(1)581/14-15(04))
15 February 2016	FA Panel discussed the proposed budget of SFC for 2016-2017	Administration's paper (LC Paper No. CB(1)440/15-16(05)) Minutes (LC Paper No. CB(1)803/15-16)

Date	Event	Papers/Minutes of meeting
22 June 2016	The Annual Report 2015-2016 of SFC was tabled at the meeting of the Legislative Council	Annual Report 2015-16
9 November 2016	Hon Mrs Regina IP raised an oral question regarding proposed enhancements to decision-making and governance structure for listing regulation	Hansard
30 November 2016	The Legislative Council passed the motion on "Formulating a comprehensive listing policy"	Hansard Wording of the motion passed
6 February 2017	FA Panel discussed the proposed budget of SFC for 2017-2018	Administration's paper (LC Paper No. CB(1)502/16-17(06)) Minutes (LC Paper No. CB(1)788/16-17)
14 June 2017	The Annual Report 2016-2017 of SFC was tabled at the meeting of the Legislative Council	Annual Report 2016-17