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Panel on Financial Affairs
Meeting on 19 February 2019

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 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 2014-2015 to 2018-2019.

Background

Establishment, regulatory objectives and organizational structure

2. SFC was established under the then Securities and Futures Commission Ordinance in 1989 as the statutory regulator of the securities and futures market in Hong Kong. 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 2018, the actual staff strength of SFC was 887,[2] consisting of 701 professional staff and 186 support staff. The organizational structure of SFC as at March 2018 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 since 1993-1994 through collecting transaction levies from investors and fees and charges from market intermediaries, 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 year to CE for approval.[3] The approval authority was delegated to FS in 1995. Under section 13(3) of SFO, FS shall

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[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 2017-2018 budget of the Securities and Futures Commission ("SFC") was 944.

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

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

7. According to section 396 of SFO, if SFC's reserves, after deducting depreciation and all provisions, are more than twice its estimated operating expenses for a financial year 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 2014-2015 to 2018-2019 at the meetings on 7 February 2014, 2 February 2015, 15 February 2016, 6 February 2017 and 5 February 2018 are summarized in the ensuing paragraphs.

Levies, licensing fees and measures to address budget deficit

9. During the discussion on SFC's proposed budgets for the past few financial years, members noted that SFC continuously hold huge reserves. Panel members had called on SFC to consider waiving or reducing the levies and fees charged on investors and market participants respectively.

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[4] SFC's approved budgets were tabled at the Council meetings on 28 May 2014, 27 May 2015, 4 May 2016, 17 May 2017 and 16 May 2018. SFC's annual reports were tabled at the Council meetings on 25 June 2014, 17 June 2015, 22 June 2016, 14 June 2017 and 27 June 2018.

[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.

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. For licensing fees,[6] SFC advised that the principle of full cost recovery was adopted. It had offered an annual licence fee waiver with effect from 1 April 2009. The annual licence fees waiver had continued since 1 April 2012 to mid March 2019.

11. 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%. 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.

12. 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 as specified in section 396 of SFO.

13. Some members raised questions about the projected deficit of SFC in its proposed budgets for 2015-2016 and 2018-2019. At the FA Panel meeting on 2 February 2015, in view of the projected budget deficit, 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"). During the discussion of SFC's proposed budget for 2018-2019 at the FA Panel meeting on 5 February 2018, members enquired how SFC would meet the projected deficit.

14. SFC advised that it 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. SFC pointed out that a substantial part of its reserves was built up in 2007-2008 because of the extraordinarily large market turnover at that time. In recent years, the income from levy could no longer meet SFC's operational needs, and

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6 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.

SFC had to rely on its reserves to meet the funding gaps while maintaining the levy rate. As the market turnover was the key driver of SFC's income, SFC could only achieve a balanced budget in 2018-2019 if the daily average market turnover reached around $120 billion.

Investment of the reserve fund

15. When FA Panel discussed SFC's proposed budget for 2015-2016, members enquired about details of the investment strategy of 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 the past five financial years, members noted with concern SFC's increasing headcounts and staff cost as well as professional and other expenses. Members urged SFC to consider increase in headcount carefully to ensure prudent use of public resources.

18. SFC stressed that 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.

19. 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.

20. At the FA Panel meeting on 5 February 2018, SFC advised that the Budget Committee and Remuneration Committee, which consisted of independent board members of SFC, would examine the proposed increases in manpower and level of remuneration in a prudent manner. In coping with increase in workload, SFC would first try to meet the shortfall in manpower through internal redeployment before creating new posts as a last resort. In fact, since the global financial crisis, SFC's manpower was considered undersized and hence had constrained its operational capabilities. As a result, the subsequent considerable growth in SFC's headcounts was a deliberate move. Since 2016, it was felt that the need for further growth had to be slowed down and the annual increase in headcount was thus kept under 3% in the past two years. Headcount increase was expected to level off in the next few years.

Regulatory and enforcement work

Striking a balance between market regulation and development

21. When FA Panel discussed SFC's proposed budgets from 2014-2015 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.

22. 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. SFC 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. 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 would continue to engage the industry when taking forward regulatory initiatives.

23. 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.

24. 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. 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. In order to provide more clarity in advance of the coming into force of the new requirement, SFC issued a circular in December 2016 which 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

25. 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.

26. 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 market 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

27. 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.

28. 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

29. 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.

30. 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.

Cyber security and online securities accounts services

31. When FA Panel discussed SFC's proposed budget for 2017-2018, some members enquired about SFC's plan to increase resources for enhancing its cyber security.

32. SFC responded that it would increase expenditure on information and system services in 2017-2018 including upgrading software and implementing new measures to enhance system security. To improve cyber security in the securities industry, apart from organizing workshops for the industry, SFC was working on a proposal to introduce cyber security baseline requirements in the Code.

33. When FA Panel discussed SFC's proposed budget for 2018-2019, some members conveyed the industry's views that SFC should assist firms to set up an online system including identity verification process and secured trading, to allow investors from the Mainland to open securities accounts in Hong Kong. These members enquired about SFC's work in following up the matter with the relevant Mainland authorities.

34. Regarding online account opening, SFC advised that the key would be to ensure the process would comply with the requirements of the relevant laws and regulations of the Mainland and that a sufficiently robust client identity verification process was in place. SFC's codes and circulars had clarified that client identity verification could be assisted by a third party such as certification agents or via signing off by professionals. Furthermore, SFC's Intermediaries Division had been in discussion with the Hong Kong Association of Online Brokers in exploring how technological advances could facilitate the development of a new non face-to-face system in opening securities accounts.

Regulation of cryptocurrencies and collective investment schemes

35. When the FA Panel discussed SFC's proposed budget for 2018-2019, some members expressed concern about the financial risks arising from cryptocurrencies in Hong Kong and enquired about SFC's work in stepping up its regulation on cryptocurrencies.

36. SFC advised that governmental and regulatory bodies worldwide including SFC were exploring measures to enhance protection for investors as existing rules were limited in regulating activities relating to cryptocurrencies. While under the existing regulatory regime, a cryptocurrency transaction would fall under SFC's regulatory purview only if it involved securities or collective investment schemes, many cryptocurrency transactions nowadays had been

structured with the attempt to circumvent SFC's regulatory purview, and such phenomenon was not unique for Hong Kong. SFC would study cryptocurrency activities and review its powers in a holistic manner and also provide targeted education programmes to investors.

37. During the discussion of SFC's proposed budget for 2018-2019, some members pointed out that investors who had suffered losses from investment in collective investment schemes involving overseas properties had expressed concern that SFC had not provided responses nor disclosed the results of its investigation regarding their complaints.

38. SFC responded that its investigations of alleged illegal fund-raising on investment in overseas properties depended on whether such activities were related to unauthorized collective investment schemes. Given that the companies involved were often overseas companies, this had limited SFC's ability in obtaining redress for Hong Kong investors who had suffered losses. SFC had been implementing preventive measures such as conducting surveillance on advertisements of overseas properties to identify suspected collective investment schemes. SFC had also liaised with the Estate Agents Authority and conducted investor education work on unauthorized collective investment schemes involving real estate.

<u>Office premises</u>

39. During the discussions of SFC's proposed budgets from 2014-2015 to 2018-2019, members made suggestions to SFC on leasing offices or purchasing its own offices. Members considered that SFC should lease offices in districts with lower office rentals than those in Central. Members also had different views on whether SFC, being a regulatory body, should use its reserves to purchase its own offices. There were views that SFC should consider acquiring office premises in non-prime locations. 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 LegCo's approval for the purchase. There was also concern about whether the ring-fenced amount of $3,000 million would be adequate given that the prices of office premises at business districts had substantially increased in recent years.

40. SFC responded that it was estimated that SFC would require an office premises of about 180 000 square feet, which would cost about $7,000 – $8,000 million based on market price in 2018. Although SFC could borrow the shortfall of $4,000 – 5,000 million, it would be a huge financial burden for SFC. As the current lease of SFC office would expire in 2022 (with the option to

terminate the lease earlier in 2020), SFC would conduct a detailed assessment of the accommodation options, and was open to all cost effective accommodation options including relocating the office premises to areas outside the core Central district.

Recent development

41. SFC and the Government will brief FA Panel on SFC's proposed budget for the financial year 2019-2020 at the meeting on 19 February 2019.

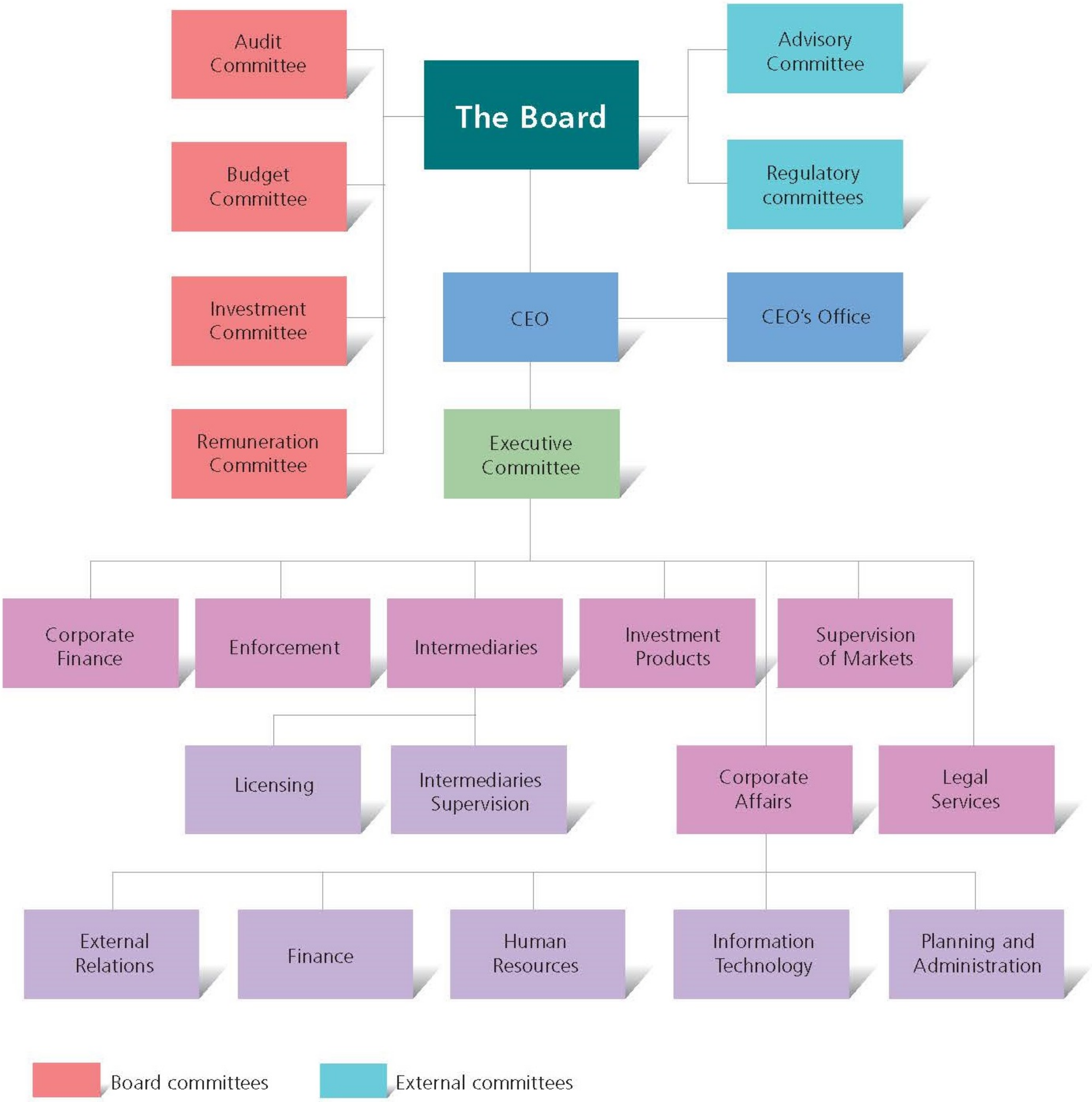
Relevant papers

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

Council Business Division 1
Legislative Council Secretariat
14 February 2019

Appendix I

Organization structure of the Securities and Futures Commission



Source: SFC's Annual Report 2017-18

\# CEO's Office includes four units, namely the Commission Secretariat, International Affairs, Mainland Affairs and Press Office.

Appendix II

List of relevant papers

Date	Event	Papers/Minutes of meeting
7 February 2014	FA Panel discussed the proposed budget of SFC for 2014-2015	Administration's paper (LC Paper No. CB(1)804/13-14(04)) Minutes (LC Paper No. CB(1)1658/13-14) Follow-up paper (LC Paper No. CB(1)1039/13-14(02))
2 February 2015	FA Panel discussed the proposed budget of SFC for 2015-2016	Administration's paper (LC Paper No. CB(1)445/14-15(05)) Minutes (LC Paper No. CB(1)781/14-15) Follow-up paper (LC Paper No. CB(1)581/14-15(04))
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)
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

Date	Event	Papers/Minutes of meeting
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
8 November 2017	Hon CHAN Chun-ying raised a written question regarding regulation of the offering and trading of digital tokens	Hansard
29 November 2017	Hon Kenneth LEUNG raised a written question regarding real-time investor identification system for northbound cross-boundary stock trading	Hansard
5 February 2018	FA Panel discussed the proposed budget of SFC for 2018-2019	Administration's paper (LC Paper No. CB(1)530/17-18(03)) Minutes (LC Paper No. CB(1)883/17-18)
27 June 2018	The Annual Report 2017-2018 of SFC was tabled at the meeting of the Legislative Council	Annual Report 2017-18