立法會
Legislative Council

LC Paper No. CB(1)365/19-20(07)
Ref: CB1/PL/FA

Panel on Financial Affairs
Meeting on 3 February 2020

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 2015-2016 to 2019-2020.

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 2019, the actual staff strength of SFC was 910,[2] consisting of 727 professional staff and 183 support staff. The organizational structure of SFC as at March 2019 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

---

[1] Section 1 of Part 1 of Schedule 2 to the Securities and Futures Ordinance (Cap. 571) ("SFO") provides for the composition of the Board of Directors.

[2] The budgeted headcount in the 2019-2020 budget of the Securities and Futures Commission ("SFC") was 988.

[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 except 2019, 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 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 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 2015-2016 to 2019-2020 at the meetings on 2 February 2015, 15 February 2016, 6 February 2017, 5 February 2018 and 19 February 2019 are summarized in the ensuing paragraphs.

<u>Levies, licensing fees and measures to address budget deficit</u>

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

---

[4] SFC's approved budgets were tabled at the Council meetings on 27 May 2015, 4 May 2016, 17 May 2017, 16 May 2018 and 16 October 2019. SFC's annual reports were tabled at the Council meetings on 17 June 2015, 22 June 2016, 14 June 2017, 27 June 2018 and 16 October 2019.

[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 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. SFC 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 end-March 2019. SFC would resume collecting the annual licensing fees from 1 April 2019 in a phased approach by introducing a 50% discount in the fees for 2019-2020 and 2020-2021. The annual licensing fees would be fully reinstated from 2021-2022 onwards.[7]

11. 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 address the projected deficit problem.

12. SFC advised that it did not have plans to impose a levy on the northbound trading under S-HK SC at the current stage. 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 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

13. When FA Panel discussed SFC's proposed budgets for 2015-2016 and 2019-2020, members enquired about SFC's strategies in investing and managing its reserves including whether SFC would consider adopting the Exchange

---

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.

7 On 4 December 2019, SFC announced that having taken into account the challenging market environment, it would waive the annual licensing fees for 2020-2021 so as to relieve the regulatory cost burden on the securities and futures industry.

Fund's ("EF") investment strategies in view of the good investment performance of EF.

14. SFC responded that its reserves were not as sizeable as EF, and SFC 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 external 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

15. During the discussions of SFC's proposed budgets for the past five financial years, members noted with concern SFC's increasing headcounts, staff costs, as well as professional and other expenses. Members urged SFC to consider any increase in headcounts carefully to ensure prudent use of public resources. Some members enquired when SFC expected to reach the optimal staff size and cease expansion in its establishment. Questions were also raised on how SFC determined the salaries of staff, and how SFC's salary levels compared with the private sector.

16. 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 and 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 other 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. It was difficult for SFC 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.

17. When FA Panel discussed SFC's proposed budgets for 2017-2018, 2018-2019 and 2019-2020, SFC advised that its 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 and objective 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. Since the global financial crisis, SFC's manpower was considered undersized and hence had constrained its operational capabilities. The considerable growth in SFC's headcounts in subsequent years was a deliberate move. Further growth in headcounts had slowed down since 2016 and the annual increase in headcount was kept under 3%. Headcount increase was expected to level off in the next few years. SFC also pointed out that its establishment size in the proposed 2019-2020 budget (i.e. 988) was largely optimal.

18. On the determination of staff salaries, SFC advised at the FA Panel meeting on 19 February 2019 that since SFC primarily recruited talent from the private sector, it needed to benchmark staff salaries against the market. SFC each year engaged external consultants to conduct surveys on salary benchmarks in the private sector, and would take into account other relevant considerations including staff turnover rates at various levels.

Regulatory and enforcement work

Striking a balance between market regulation and development

19. When FA Panel discussed SFC's proposed budgets for 2015-2016 and 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 various 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.

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 to tighten regulation over 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.

21. 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.

22. 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

23. During the discussion of SFC's proposed budget for 2016-2017, some members expressed concern that the dual role of the Hong Kong Exchanges and Clearing Limited ("HKEX") as a listed company and the frontline regulator of listing matters might give rise to conflict of interest, and cast doubt on the independence of the Listing Committee. They asked whether SFC would consider taking over HKEX's role as the frontline regulator.

24. 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. SFC would make its best endeavours to ensure the independence and effectiveness of the Listing Committee.

Backdoor listings of Mainland companies

25. 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.

26. 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

27. When FA Panel discussed SFC's proposed budgets for 2017-2018 and 2019-2020, some members enquired about SFC's resources and measures for enhancing cyber security.

28. 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, and would conduct regular checks on its information technology security systems to mitigate the risks of hacking. In order 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.

29. 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 facilitate 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.

30. 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 virtual assets and collective investment schemes

31. When FA Panel discussed SFC's proposed budgets for 2018-2019 and 2019-2020, some members expressed concern about the financial risks arising from virtual assets including cryptocurrencies in Hong Kong and enquired about SFC's work in stepping up its regulation on virtual assets.

32. SFC advised that 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. Such phenomenon was not unique for Hong Kong. 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 virtual assets. Financial regulators worldwide, including Central Banks, were of the view that due to the relatively small size of virtual assets trading in the market, such trading activities posed limited risk to financial stability at the moment. In November 2018, SFC launched a new regulatory approach for the management or sale of virtual asset funds to protect interests of investors, and for virtual asset trading platform operators to opt in to the regulation by SFC via a Sandbox environment on a voluntary basis. SFC stressed that the new regulatory approach was exploratory and still evolving. SFC would discuss with potential virtual assets trading platform operators with a view to determining whether such platforms were suitable to be regulated by SFC.

33. 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.

34. 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.

Digitalization of the Securities and Futures Commission's services

35. During the discussion of SFC's proposed budget for 2019-2020, some members raised enquiries about SFC's plans to digitalize its services, e.g. introducing e-approval in the authorization of financial products, and allowing e-submission of documents to SFC.

36. SFC pointed out that digitalization was the way forward in the financial services sector. While complete digitalization for SFC's processes would take time, SFC was exploring the feasibility to integrate all of its internal systems and was progressing in the use of Cloud services. To prepare for full digitalization of all the interfaces between SFC and its licensees in 2019, SFC was revamping its licensing forms to allow e-filing of documents.

Office premises

37. During the discussions of SFC's proposed budgets from 2015-2016 to 2019-2020, 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.

38. SFC responded that taking into account its development needs, it was estimated that an office premises of about 180 000 square feet would be required, 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 lease of SFC office in Central 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.

39. At the FA meeting on 19 February 2019, SFC pointed out that an office premises of a considerable size required by SFC was in limited supply in the market. SFC planned to move to a new office in Quarry Bay in the second quarter of 2020, which was envisaged to achieve savings of about $1,000 million in rentals over the eight-year lease. Together with the ring-fenced $3,000 million for purchase of its office, SFC would have about $4,000 million at its disposal for the acquisition of a new office in a commercial building. It was estimated that the total ring-fenced amount could contribute to 40% to 50% of the total purchase cost. In case of insufficient funds, SFC would consider making arrangement for a loan for the purpose.

Recent development

40. SFC and the Government will brief FA Panel on SFC's proposed budget for the financial year 2020-2021 at the meeting on 3 February 2020.

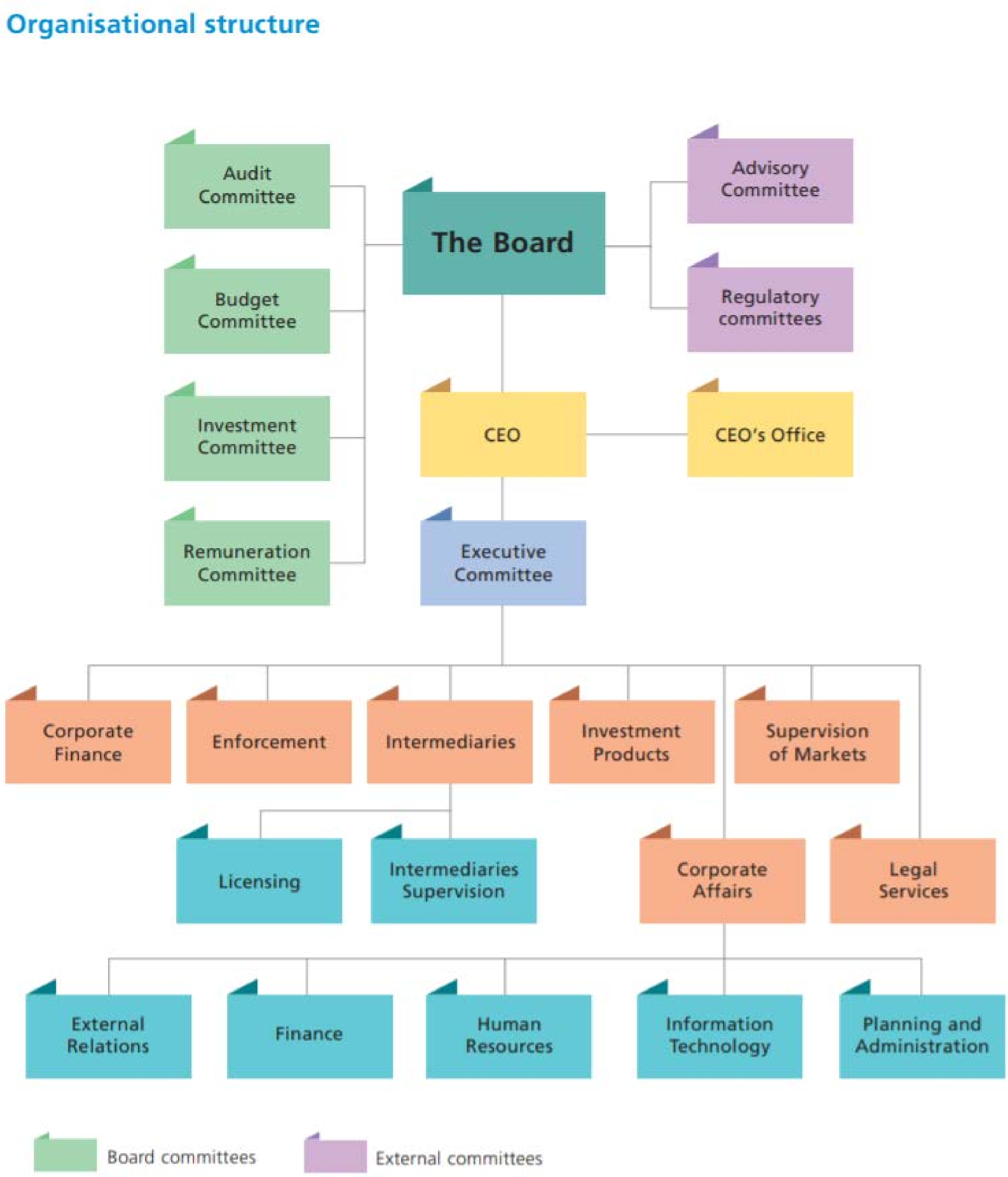
Relevant papers

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

Council Business Division 1
<u>Legislative Council Secretariat</u>
23 January 2020

Appendix I

Organization structure of the Securities and Futures Commission



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

Source: SFC's Annual Report 2018-2019

Appendix II

List of relevant papers

Date	Event	Papers/Minutes of meeting
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))
17 June 2015	The Annual Report 2014-2015 of SFC was tabled at the meeting of the Legislative Council	Annual Report 2014-2015
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 2015-2016
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 Progress report

Date	Event	Papers/Minutes of meeting
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 2016-2017
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 2017-2018
19 February 2019	FA Panel discussed the proposed budget of SFC for 2019-2020	Administration's paper (LC Paper No. CB(1)556/18-19(04)) Minutes (LC Paper No. CB(1)951/18-19)

Date	Event	Papers/Minutes of meeting
25 March 2019	SFC announced that it would resume the collection of annual licensing fees on 1 April 2019	SFC's circular
16 October 2019	The Annual Report 2018-2019 of SFC was tabled at the meeting of the Legislative Council	Annual Report 2018-2019
4 December 2019	SFC announced that it would waive the annual licensing fees for 2020-2021	SFC's press release