Panel on Financial Affairs
Legislative Council
Securities and Futures Commission Budget
for the Financial Year 2000-01

INTRODUCTION

The budget of the Securities and Futures Commission ("SFC") for 2000-01 is submitted at the Enclosure for Members' information. This note highlights the main features of the 2000-01 budget and compares the approved budget for 1999-2000 with the latest estimates. Members may wish to note that, for the eighth consecutive year, the SFC has requested the Government not to make an appropriation for the financial year 2000-01.

BACKGROUND

2. On 12 April 1989, Members noted the following procedures for the approval of the SFC budget (FCR(89-90)12) -

(a) the SFC will submit its budget to the Administration for the next financial year before 31 December;

(b) the Administration will examine the SFC budget in January and present it to the Finance Committee for information in January/February;

(c) the Administration will then submit the SFC budget to the Chief Executive for approval in February; and

(d) the Administration will table the approved SFC budget in the Legislative Council and will, at the same time, submit the request for recurrent Government grant in the context of the draft Estimates.

In 1995, the authority for approval for SFC budgets was delegated to the Financial Secretary.

3. The SFC submitted in December 1999 its budget for 2000-01 to the Financial Secretary. The budget was revised on 30 March 2000 incorporating the latest adjustment of its estimated levy income on securities transactions which constitutes the major source of income for the SFC in the light of the changes in market activities in the first quarter of 2000, as well as the proposed change in the split of the levy income between the SFC and the Stock Exchange of Hong Kong Limited ("SEHK") following the realignment of the regulatory function between the two organisations upon the completion of the merger of the exchanges and their associated clearing houses (please see paragraph 5 below for details), hence the delay in this submission.

FUNDING OF THE SFC

4. Part VII of the SFC Ordinance provides that the SFC may be financed by transaction levies, government appropriation and fees and charges on services rendered to market operators and participants. Since 1993-94, the SFC has not requested for government appropriation, and as a result, the funding of the SFC today has practically come entirely from the market in the form of levies and fees and charges.

5. SFC's levy income comes from the securities and futures markets. The current rate of levy on securities transaction is 0.011% and is shared between the SFC and the SEHK in the ratio of 4:7. After the merger of the exchanges, the function of the supervision of exchange participants has been transferred from the SEHK to the SFC. It is therefore proposed that 0.001 percentage point out of the SEHK's share of the levy be transferred to the SFC to meet the increase in its operating costs for the additional duties while offsetting the savings in the SEHK. Separately, out of the SEHK's share of the levy income, 0.001 percentage point is at present diverted to the Development Reserve to support development of SEHK's infrastructure. Given the commercial nature of the Hong Kong Exchanges and Clearing Limited which wholly owns the SEHK, it is considered no longer appropriate to fund its Development Reserve through a statutory levy. It is therefore also proposed that 0.001 percentage point out of the SEHK's share should be removed. These proposals would as a result reduce the rate of the transaction levy from 0.011% to 0.01% and reallocate the levy income between the SFC and the SEHK on a 50:50 basis. A Securities and Futures Commission (Levy)

(Securities) (Amendment) Order to give effect to these proposals will shortly be introduced into the Legislative Council for negative vetting. The current levy for futures contracts trading will remain unchanged at $1 per leviable transaction on both the buyer and seller.

6. As regards fees and charges, the SFC adopts, to the extent possible, the principle of full cost recovery when setting the level of its fees and charges. However, the rates of SFC fees and charges have not been revised since 1994. Despite two attempts to adjust the rates of fees and charges to maintain the full cost recovery principle against inflation, the amendment rules for the proposed fees and charges revision were revoked twice by the then Provisional Legislative Council on 15 October 1997 and 26 March 1998. Following the government's policy to gradually adjust public fees and charges to recover costs, the SFC has planned to review its level of fees and charges later this year with a view to proposing adjustments in line with the prevailing economic conditions. The implications of any fee adjustments on the budget are however excluded for the purpose of compiling the present estimates.

7. As regards funding by the Government, an annual grant may be given to the SFC as a stable source of income to offset the more volatile income from the levy and from fees and charges. In accordance with FCR (89-90)12, such a grant should be equivalent to the cost to the Government in 1988 of funding the former Office of the Commissioner for Securities and Commodities Trading, less income. The Government will provide the provisional grant at the beginning of each financial year, with a reconciliation and, if necessary, adjustment made for the previous financial year. The grant in 1992-93 amounted to $60 million.[1] There is also an emergency fall-back whereby SFC can seek loans with the approval of the Finance Committee to enable the Commission to survive any exceptionally prolonged period of low market activities.

8. Owing to a gradually increasing turnover since 1993 and a reasonable level of reserves, the SFC has for the eighth consecutive year not requested for government grant. As a result, the total grant so far foregone amounts to about $ 592 million.

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[1] Should a grant be requested for in 2000-2001, the grant is estimated to be about $ 96 million.

BUDGET FOR 2000-01

9. The main features of the 2000-01 budget are as follows:-

(a) estimated revenue for 2000-01 is $433 million, which represents about 1.4% or 6 million **below** the latest estimate for 1999-2000 ($439 million), notwithstanding an increase in levy income on securities transactions from $229 million to $270 million.[2] The reduction in overall revenue for the SFC is attributable mainly to –

- a reduction of income from fees and charges by over 30% or $41 million over the latest estimate because of an anticipated lower level of application of investment products following a peak of such activities in 1999-2000;

- a reduction in investment income by 10% or $6 million because of the contraction of the SFC reserve to finance its deficit and the actual payment of the balance ($100 million) of the first tranche of contribution to the Unified Exchange Compensation Fund[3] ("UECF") committed in 1998 in relation to the C.A. Pacific default.

(b) estimated operating expenditure will increase to $452 million, or 19% **above** the latest estimates for 1999-2000. This is mainly attributable to a significant increase in personnel expenses by 21% or $57 million over the latest estimates resulting from an expansion of headcount from 312 by 13% to a total of 353 staff (most of the increase in headcount is to cater for the regulation of exchange participants taken over from the two exchanges after merger) and a shift towards a higher ratio of professional staff to general staff. The SFC has no plan in the budget to adjust the annual salary of its staff. Other items of

[2] The increase has taken into account the proposed transfer of 0.001 percentage point from the SEHK's share of 0.007 % of the consideration of a transaction to the SFC. The transfer is to cater for the additional operating costs to be incurred by the SFC for taking over from the SEHK the supervision of exchange participants after the merger of the exchanges and their associated clearing houses.

[3] The UECF is provided for by the Securities Ordinance to cater for claims for compensation by any person who has suffered pecuniary loss as a result of a default on the part of a broker member (now exchange participant) in the SEHK.

major increase and decrease in budgeted expenditure include –

- information and system services (increase by 61% or $4 million), for the provision for the maintenance of the SMARTS (Securities Market Automated Research) system and Oracle[4], as well as for the maintenance charges for an offsite data backup office;

- training and development (increase by 113% or $6 million) for more training programmes for the executives following the increase in establishment and for enhancing their productivity;

- professional and others (increase by 32% or $11 million) for projected increase in legal fees, recruitment expenses and external professional services for handling appeal cases in respect of the disciplinary cases possibly taken over upon the transfer of the functions from the two exchanges This item also includes $5 million for the engagement of external services in relation to the implementation of the recommendations of the Steering Committee on the Enhancement of the Financial Infrastructure[5];

- premises (decrease by 23% or $ 10 million) as a result of lower rentals following market adjustments.

(c) an **estimated deficit** of $41 million is expected, as compared with an anticipated surplus of $41 million in the latest estimates for 1999-2000; and

(d) as a result, estimated reserves are expected to fall to $743 million by the end of the 2000-01 financial year from $784 million as at

[4] SMARTS is an automated surveillance and trading analysis system acquired for analysing market data to assist the Enforcement Division in monitoring trading on exchanges. Oracle is a relational database management system which provides the SFC with an open system architecture that is hardware independent.

[5] The Committee was set up by the Financial Secretary and chaired by the Chairman of the Securities and Futures Commission. The Committee completed in October 1999 a report on the recommendations to upgrade Hong Kong financial infrastructure. The most important recommendation of the report is the establishment of an open and secure electronic network that will allow securities and derivatives transactions to be processed in a straight-through manner.

the end of the 1999-2000 financial year as anticipated in the latest estimates. The estimated reserve ($743 million) is equivalent to about 19 months of the proposed operating expenditure for 2000-01. If the SFC is to make the second tranche contribution of $150 million to the UECF, the reserve will be further reduced to $593 million, or 15 months of the proposed annual operating expenditure, which is considered healthy and within the threshold of two years' operating expenditure stipulated in the SFC Ordinance.

A projected income and expenditure statement and a projected balance sheet for the year 2000-01 are on pages 4.1 and 4.2 of the Enclosure.

COMPARISON OF THE APPROVED BUDGET WITH THE LATEST ESTIMATES FOR 1999-2000

10. The agreement between the Government and the SFC is that the actual total expenditure of the SFC should not exceed the approved budget by more than 10% without the prior approval of the Financial Secretary. The table on page 2.5 of the Enclosure provides a comparison of the approved budget and the latest estimates for 1999-2000. The salient features are –

(a) Revenue

The SFC projected that the total revenue would increase by $129 million in the 1999-2000 latest estimates, mainly due to the substantial increase in the daily turnover in the Stock Exchange, which reached about $ 11.39 billion for 1999-2000 as opposed to the average daily turnover of $ 6 billion as originally assumed in the approved estimates. The increase in fees collected in relation to takeovers and mergers and the higher than expected investment income have also contributed to the overall increase in revenue.

(b) Operating Expenditure

The total operating expenditure has been projected downward from $421 million to $381 million following a general decrease of costs most notably in the personnel expenses (from $298 million to $274 million) mainly due to under spending as a result of the slippage in recruitment exercises and the trimming of the establishment for existing operation.

(c) Capital Expenditure

The estimated expenditure on "furniture and fixtures" are revised upward by $5.77 million to cater for office expansion project. The increase will be offset by deferment of other items to 2000/01 and absorbed by contingency provision under capital expenditure. As a result, the latest estimates for capital expenditure for 1999-2000 stays in line with the approved estimates.

ADMINISTRATION'S VIEWS

11. The Administration has carefully examined the SFC budget for 2000-01 and is satisfied that SFC has made efforts to reduce expenditure as far as possible without deteriorating its services quality and regulatory functions.

12. Notwithstanding the $ 41 million deficit in the estimate, the SFC has for the eighth consecutive year decided not to request an appropriation of annual grant from the Government.

13. Although the budget assumes the same level of fees and charges for SFC throughout the financial year, it indicates in page 2.7 of the Enclosure that the Commission has planned to review its level of fees and charges later this year with a view to proposing adjustments in line with the then prevailing economic conditions. The Administration supports the proposed review in order to gradually bring the fees more in line with full cost recovery policy.

14. The budgeted deficit will be absorbed by the SFC's reserves, which are expected to decrease to $ 743 million by the end of 2000-01 financial year, or 1.56 times of the total operating expenditure (including depreciation) for 2000-01. If the SFC's second tranche contribution of $150 million to the UECF is taken into account, the reserve level will be further reduced to $593 million, or 15 months of the proposed annual operating expenditure.

15. Despite the anticipated reduction of the reserve due to the budget deficit, the Administration considers that SFC's financial position remains at a prudential level and the projected deficit should not have any significant adverse effect on its normal operations or the performance of its statutory functions.

16. Since the financial year of the SFC commences on 1 April 2000 and due to the slippage in the dealing with the 2000-01 budget as explained in paragraph 3 above, the Financial Secretary has approved the SFC budget for 2000-01 on 31 March in order to enable the SFC to incur expenses for its continued operation beyond 1 April 2000. However, the Financial Secretary would be prepared to consider reviewing or modifying the approval in the light of any substantive and justifiable comments of the Panel on Financial Affairs.

Financial Services Bureau
12 April 2000