

Unified Exchange Compensation Fund (the Fund)

Report of the Securities Compensation Fund Committee (the Committee)

The members of the Committee present their annual report and the audited financial statements for the year ended 31 March 2003.

1. Establishment of the Fund

Part X of the Securities Ordinance (Chapter 333) established the Fund.

2. Financial results

The Committee presents the financial results which are set out in the financial statements on pages 94 to 103.

3. Members of the Committee

The members of the Committee during the year and up to the date of this report were:–

Mr Mark Dickens, JP

Mrs Alexa Lam

Mr David M Roberts

Mr Kwong Ki Chi, GBS, JP (nomination revoked on 16 April 2003)

Mr T Brian Stevenson, SBS

4. Interests in contracts

No contract of significance to which the Fund was a party and in which a Committee member had a material interest, whether directly or indirectly, subsisted at the balance sheet date or at any time during the year.

5. Auditors

The retiring auditors, Messrs. KPMG, being eligible, offer themselves for re-appointment.

On behalf of the Committee

Mark Dickens

Chairman

5 May 2003

Auditors' Report to the Securities & Futures Commission (the SFC)

We have audited the financial statements of the Unified Exchange Compensation Fund (the Fund) established under Section 99 of the Hong Kong Securities Ordinance set out on pages 94 to 103 which have been prepared in accordance with International Financial Reporting Standards promulgated by the International Accounting Standards Board.

Respective Responsibilities of the SFC and Auditors

The Hong Kong Securities Ordinance requires the SFC to keep proper accounts of the Fund and to prepare financial statements of the Fund in respect of each financial year. The directors of the SFC do so on the basis that these financial statements should give a true and fair view. In preparing financial statements which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently, that judgements and estimates are made which are prudent and reasonable and that the reasons for any significant departure from applicable accounting standards are stated.

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion to you.

Basis of Opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the SFC in the preparation of the financial statements and of whether the accounting policies are appropriate to the Fund's circumstances, have been consistently applied and are adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the financial statements are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion the financial statements give a true and fair view of the state of affairs of the Fund at 31 March 2003 and of its surplus and cash flows for the year then ended, and have been properly prepared in accordance with International Financial Reporting Standards promulgated by the International Accounting Standards Board.

KPMG

Certified Public Accountants
Hong Kong

5 May 2003

Income and Expenditure Account

For the year ended 31 March 2003 (Expressed in Hong Kong dollars)

	Note	2003 \$'000	2002 (Restated) \$'000
Income			
Net investment income	4&6	40,541	47,315
Transaction levy	4&7	68,560	41,181
Recoveries	4	720	3,905
		109,821	92,401
Expenses			
Provision for compensation made	4&10	20,034	23,406
Unused provision for compensation reversed	4&10	(4,443)	(85,073)
Recoveries re-distributed to claimants	4	1,868	2,482
Auditors' remuneration		41	41
Bank charges		253	218
Exchange difference		11	–
Professional fees		196	807
Sundry expenses		5	5
		17,965	(58,114)
Surplus for the year		91,856	150,515
Accumulated deficit brought forward	4	(256,992)	(407,507)
Accumulated deficit carried forward		(165,136)	(256,992)

The notes on pages 98 to 103 form part of these financial statements.

Balance Sheet

At 31 March 2003 (Expressed in Hong Kong dollars)

	Note	2003 \$'000	2002 (Restated) \$'000
Current assets			
Debt securities	8	555,930	728,519
Contributions receivable		–	30,000
Interest receivable		5,580	8,383
Levy receivable		5,607	6,248
Fixed and call deposits with banks		339,687	49,723
Cash at bank		17	211
		906,821	823,084
Current liabilities			
Accounts payable and accrued charges		4,590	2,724
Provision for compensation	4&10	30,628	40,613
		35,218	43,337
Net current assets		871,603	779,747
Net assets		871,603	779,747
Representing:			
Compensation fund			
Contributions from the SEHK	9	46,450	46,450
Excess transaction levy from the SEHK	12	353,787	353,787
Special contribution		3,500	3,500
Additional contribution from the SEHK		300,000	300,000
Additional contribution from the SFC		330,000	330,000
Special levy surplus	13	3,002	3,002
Accumulated deficit		(165,136)	(256,992)
		871,603	779,747

Approved and authorised for issue by the Securities Compensation Fund Committee on behalf of the Securities and Futures Commission on 5 May 2003 and signed on its behalf by

Mark Dickens
Chairman

Alexa Lam
Committee Member

T Brian Stevenson
Committee Member

The notes on pages 98 to 103 form part of these financial statements.

Statement of Recognised Gains and Losses

For the Year Ended 31 March 2003 (Expressed in Hong Kong dollars)

	Note	2003	2002 (Restated)
		\$'000	\$'000
Surplus for the year		91,856	150,515
Total recognised gains		91,856	150,515
Effect of change in accounting policy	4	(494,770)	(599,041)

Cash Flow Statement

For the year ended 31 March 2003 (Expressed in Hong Kong dollars)

	2003	2002 (Restated)
	\$'000	\$'000
Net cash inflow from operating activities	43,837	16,424
Returns on investments – interest received	43,996	38,207
Investing activities		
Debt securities redeemed	391,500	123,000
Debt securities bought	(219,563)	(332,229)
Net cash inflow/(outflow) from investing activities	171,937	(209,229)
Financing		
Additional contribution from the SEHK	–	36,174
Additional contribution from the SFC	30,000	36,173
Net cash inflow from financing	30,000	72,347
Increase/(decrease) in cash and cash equivalents	289,770	(82,251)
Cash and cash equivalents at beginning of the year	49,934	132,185
Cash and cash equivalents at end of the year	339,704	49,934

Reconciliation of surplus for the year to net cash inflow from operating activities:

	2003	2002 (Restated)
	\$'000	\$'000
Surplus for the year	91,856	150,515
Net investment income	(40,541)	(47,315)
Decrease/(increase) in levy receivable	641	(6,248)
Decrease in provision for compensation	(9,985)	(82,667)
Increase in accounts payable and accrued charges	1,866	2,139
Net cash inflow from operating activities	43,837	16,424

Analysis of the balance of cash and cash equivalents as shown in the balance sheet:

	2003	2002
	\$'000	\$'000
Cash at bank	17	211
Fixed and call deposits with banks	339,687	49,723
	339,704	49,934

Notes to the Financial Statements

For the year ended 31 March 2003 (Expressed in Hong Kong dollars)

1. Status change of the SEHK members

On 6 March 2000, the Stock Exchange of Hong Kong Limited (the SEHK) became a wholly-owned subsidiary of Hong Kong Exchanges and Clearing Limited (HKEx). The members of the SEHK ceased to be SEHK shareholders and received shares in HKEx and SEHK trading rights. Most also became exchange participants of the SEHK, who are required to continue holding of a trading right.

Pursuant to the Exchanges and Clearing Houses (Merger) Ordinance, an exchange participant means a person who may trade on or through the Exchange Company and a “trading right” means a right to be eligible to trade on or through the Exchange Company. Following the status change and related changes to the legislation, claims against the Fund must be made in relation to a default by a SEHK exchange participant (formerly a member) and the SEHK must make deposits to the Fund for each trading right (formerly each share in the SEHK).

2. Purpose, limitation and principal activity

The Fund provides compensation to investors who suffer a loss due to the default of an exchange participant of the SEHK. Part X of the Securities Ordinance governs its operation.

The SEHK receives and determines claims against the Fund. The SFC maintains and invests the money of the Fund and makes payments to claimants. Upon making payment to a claimant, the SFC is subrogated to the claimant's rights against the defaulter.

The Securities Ordinance limits to \$8 million the total amount that may be paid per exchange participant default. If allowed claims exceed the limit, payments are made proportionally to claimants. The SEHK with the approval of the SFC can decide to increase the limit if it considers, among other things, that the assets of the Fund so permit. For eight defaults since 1998, the SEHK proposed and the SFC approved increases in the limit via payment of up to \$150,000 per claimant or if higher the claimant's proportional share of the \$8 million limit.

If amounts owed to claimants against the Fund exceed the Fund's net assets, the SFC would apportion compensation payments to claimants as provided in the Securities Ordinance. Unpaid claim amounts would be charged against future receipts by the Fund and paid when funds were available.

The Legislative Council enacted the Securities and Futures Ordinance (SFO) on 13 March 2002. The SFO and related subsidiary legislations came into effect from 1 April 2003.

The SFO requires the SFC to form a new single investor compensation fund (ICF) to replace the Fund and the Commodity Exchange Compensation Fund. After allowing a sufficient sum of money to meet claims against it and its other liabilities, the SFC will transfer the remaining balance of money in the Fund into the ICF after 1 April 2003. Claims for any defaults occurring after 31 March 2003 should be made against the ICF. If the sum of money in the Fund is not sufficient to meet its liabilities, the SFC shall pay into the Fund from the ICF the appropriate sum of money according to Section 242 of the SFO.

Apart from the above change and Section 112, under Section 74(1) of Schedule 10 of the SFO, Part X of the Securities Ordinance remain effective in respect of the operation of the Fund.

3. Money constituting the Fund

Before 1 April 2003, the SEHK must keep deposited with the SFC \$50,000 for each SEHK trading right under the Securities Ordinance. When the SFC makes compensation payments out of the deposits, the SFC may require the SEHK to replenish the net amount paid after the SFC has exhausted its subrogated rights against the defaulter. The SFC pays to the SEHK the investment return earned on any remaining deposits net of Fund expenses. During the year, the SFC did not make such payment as the total of the compensation payments exceeded the deposits received from the SEHK (2002: nil).

The SEHK and the SFC have made contributions of their own money to the Fund. The SFC determines to retain investment returns earned on these contributions in the Fund.

Other sources of money for the Fund include: recoveries; SEHK replenishments detailed in note 11; special levy surplus detailed in note 13; and transaction levy detailed in note 7.

4. Significant accounting policies

The Fund prepares its financial statements in accordance with International Financial Reporting Standards (IFRSs) promulgated by the International Accounting Standards Board (IASB). We set out below a summary of our significant accounting policies.

Basis of preparation of financial statements

Under the SFO, the Fund will continue in operation until all claims against it and all its liabilities have been settled. As the Fund will eventually cease operation, we have prepared these financial statements on a break-up basis with assets stated at recoverable amounts. We have not provided for potential future claims and recoveries as these cannot be reliably estimated. We have also not provided in the financial statements for all expenses expected to be incurred subsequent to the balance sheet date and up to the date operation will cease as these are estimated to be immaterial.

Change in accounting policy

In past years, we recognised investment income in the income and expenditure account and other receipts and distributions to the Fund directly. In order to improve the comprehensibility of the financial statements to readers, this year we recognise receipts (including transaction levy, recoveries and replenishments from the SEHK) and distributions (including provision made for compensation payments and re-distribution of recoveries) that are directly related to the principal activity of the Fund as income and expenses respectively in the Fund's income and expenditure account. The comparative information for the year ended 31 March 2002 has been restated retrospectively to conform to the new policy.

Accumulated surplus/(deficit) (restated)

	2003 \$'000	2002 \$'000
Accumulated surplus brought forward as previously reported	237,778	191,534
Change in accounting policy with respect to reclassification as income		
– transaction levy	41,181	–
– recoveries	25,794	21,889
– replenishments from the SEHK	16,360	16,360
Change in accounting policy with respect to reclassification as expenses		
– compensation to claimants	(563,588)	(625,255)
– recoveries re-distributed to claimants	(14,517)	(12,035)
Effect of change in accounting policy	(494,770)	(599,041)
Accumulated deficit brought forward as restated	(256,992)	(407,507)

Notes to the Financial Statements (cont'd)

For the year ended 31 March 2003 (Expressed in Hong Kong dollars)

4. Significant accounting policies (cont'd)

The effect of the change in accounting policy for the year is to cause an increase in income of \$69,280,000 (2002: \$45,086,000) representing the recognition of transaction levy and recoveries as income and an increase in expenses of \$17,459,000 (2002: decrease in expenses of \$59,185,000) representing the recognition of compensation to claimants and re-distribution of recoveries as expenses. These resulted in a net increase in surplus of \$51,821,000 for the year (2002: \$104,271,000).

Recognition of income

Net Investment income Net investment income comprised (i) interest income from bank deposits and debt securities, (ii) unrealised gain or loss on revaluation of debt securities and (iii) realised gain or loss on redemption and disposal of debt securities. We record interest income on an accrual basis.

Transaction levy We record transaction levy as income at a fixed rate of every leviable SEHK transaction on an accrual basis.

Recoveries We recognised recoveries pursuant to Section 118 of the Securities Ordinance as income to the Fund and recoveries re-distributed to claimants as expenses. Recoveries received and re-distributed are recorded on a receipt basis.

Replenishments by the SEHK We record replenishments from the SEHK pursuant to Section 107 of the Securities Ordinance as income of the Fund on a receipt basis. For the purpose of calculating the amount to be replenished by the SEHK, we deem the compensation payment up to the amount of \$8,000,000 for each default to be charged to the contribution from the SEHK.

Translation of foreign currencies

We translate foreign currency transactions during the year into Hong Kong dollars at the exchange rates ruling at the transaction dates. We translate monetary assets and liabilities denominated in foreign currencies into Hong Kong dollars at the exchange rates ruling at the balance sheet date. We record exchange gains and losses as income and expenses when they occur.

Investments

As we have prepared the financial statements on a break-up basis, we have reclassified our investments in debt securities, which were classified as held-to-maturity debt securities before the enactment of the SFO, as current assets. We state these securities at fair value with any resultant unrealised gain or loss recognised in the income and expenditure account. The fair value of the securities is their quoted bid prices at the balance sheet date. We account for purchases and sales of debt securities on the settlement date.

Impairment

We review the carrying amounts of the Funds's assets at each balance sheet date to determine whether there is any indication of impairment. If any such indication exists, we estimate the asset's recoverable amount. We recognise in the income and expenditure account an impairment loss whenever the carrying amount of an asset or its cash-generating unit exceeds its recoverable amount.

Calculation of recoverable amount

We calculate the recoverable amount of the Fund's receivables by discounting their expected future cash flows to their present value at the original effective interest rate inherent in the asset. We do not discount receivables with a short duration in the calculation of their recoverable amount.

4. Significant accounting policies (cont'd)

Reversals of impairment

We reverse an impairment loss in respect of a receivable if the circumstances and events that have led to the write down or write-off cease to exist and there is persuasive evidence that the new circumstances and events will persist for the foreseeable future.

Other receivables

We state other receivables at their cost less impairment losses.

Provision for compensation

We make provision for liabilities arising from claims resulting from defaults occurring before 1 April 2003 for which the SEHK has published a notice calling for claims pursuant to either Section 112 of the Securities Ordinance or Section 74(4) of Schedule 10 of the SFO. The provision covers all such claims received up to the date on which the financial statements are approved by the Committee.

As a result of the enactment of the amendments to Section 113 of the Securities Ordinance in November 1998, the maximum liability of the Fund to claims for each default case can exceed the normal \$8,000,000 limit.

Other payables

We state other payables at cost.

Contingent liabilities

Unless the probability of outflow of economic benefits is remote, we disclose obligation as contingent liability where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably. We also disclose possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events unless the probability of outflow of economic benefits is remote.

Related parties

For the purpose of these financial statements, we consider that the following are related parties of the Fund:

- (i) parties that the Fund has the ability, directly or indirectly, to control or to significantly influence in making financial and operating decisions;
- (ii) parties that have the ability, directly or indirectly, to control or significantly influence the Fund in making financial and operating decisions; and
- (iii) parties that are subject to common control or common significant influence.

Related parties may be individuals or corporate entities.

5. Taxation

Section 87 of the Hong Kong Inland Revenue Ordinance exempts the Fund from Hong Kong taxes.

6. Net investment income

	2003	2002
	\$'000	\$'000
Interest income from bank deposits and debt securities	34,209	37,536
Unrealised gain on revaluation of debt securities	6,332	9,779
Net investment income	40,541	47,315

Notes to the Financial Statements (cont'd)

For the year ended 31 March 2003 (Expressed in Hong Kong dollars)

7. Transaction levy

From 1 September 2001, the Fund received a transaction levy chargeable at 0.002% of every leviable SEHK transaction.

8. Debt securities

	2003	2002
	\$'000	\$'000
Maturing after one year		
In the second to third years	88,435	–
– listed outside Hong Kong	165,366	315,117
– unlisted		
After three years	44,890	40,985
	298,691	356,102
Maturing within one year		
– listed outside Hong Kong	8,406	41,673
– unlisted	248,833	330,744
	257,239	372,417
	555,930	728,519

9. Set-off of SEHK deposits and refunds

When a trading right is transferred, the SEHK must make a \$50,000 deposit with the SFC within one month of the transfer in respect of the new holder. In the absence of claims or other provisions as set out in Section 106 of the Securities Ordinance, the SFC must refund to the SEHK the deposit of the former holder within six months of the transfer. In practice, the SFC sets these amounts off against one another and does not include in these financial statements any liability of the SEHK to make a deposit during the six-month period.

The SEHK advised the SFC of eight trading rights having been transferred during the six months to 31 March 2003 (2002: 18 trading rights had been transferred during the six months to 31 March 2002).

10. Provision for compensation

	2003	2002
	\$'000	\$'000
Balance brought forward	40,613	123,280
Less: Amount paid during the year	(25,576)	(21,000)
Unused provision reversed during the year	(4,443)	(85,073)
Additional provision made for the year	20,034	23,406
Add: Net provision made/(provision reversed)	15,591	(61,667)
Balance carried forward	30,628	40,613

We made provision for claims in respect of seven SEHK exchange participants for which the SEHK has published a notice calling for claims. The maximum liabilities of the Fund in respect of six of these defaulted cases exceed the normal \$8 million limit.

11. Replenishments from the SEHK

Under Section 107 of the Securities Ordinance, the SFC may require the SEHK to replenish the Fund with an amount that is equal to that paid in connection with the satisfaction of the claim (limited to \$8,000,000 per each defaulted case) after the SFC has exhausted all relevant rights of action and other legal remedies against the defaulter.

Up to 31 March 2003, the SEHK has replenished \$16,360,000 to the Fund. In compliance with Section 107 of the Securities Ordinance, if no further recoveries were to be collected, the SFC may require the SEHK to further replenish \$66,349,000 to the Fund as follows:

	2003 \$'000
Compensation paid up to the \$8 million limit as set out in Section 109(3) of the Securities Ordinance	92,839
Less: Recoveries received	(26,515)
Add: Recoveries re-distributed to claimants	16,385
Less: Replenishments from the SEHK	(16,360)
Net amount SFC may request SEHK for replenishment	<u>66,349</u>

Under Section 74(3) of the Schedule 10 of the SFO, the SFC having allowed sufficient funds to meet claims, may reimburse the SEHK for the deposits paid by the SEHK into the Fund for each trading right. The reimbursement of these SEHK deposits may be set off against further replenishments required from the SEHK.

12. Excess transaction levy from the SEHK

The SEHK paid these amounts to the Fund from 1992 to 1994 under an agreement with the SFC and the Financial Secretary concerning the SEHK's budget and its receipt of transaction levy.

13. Special levy surplus

In November 2000, the Financial Services Bureau of the HKSAR Government transferred to the Fund \$3,002,000 under the provisions of the Exchanges (Special Levy) Ordinance.

14. Related party transactions

We have related party relationship with the SFC and the SEHK. During the year, there were no significant related party transactions other than those disclosed in the financial statements (refer to notes 7,9,11 and 12).

15. Financial instruments

Financial assets of the Fund comprise debt securities.

(i) Credit risk

The Fund's investment policy only allows the Fund to invest in fixed rate dated securities or in bank deposits. The policy also limits the Fund's exposure to each organisation and each country to not more than 15% and 20% of the total investment respectively. During the year, the Fund complied with the above investment policy and, as a result, was not exposed to significant credit risk.

(ii) Exchange rate risk

The Fund's investment policy allows the Fund to invest in US dollar dated securities. As the HK dollar is pegged with the US dollar, the Fund was not exposed to significant foreign exchange risk.

(iii) Market risk

The investment activities of the Fund expose it to various types of market risks which are associated with the markets in which it invests, to the extent of the amount invested in debt securities. Such risk will be reflected in the price and the carrying value of the financial assets concerned.

16. Contingent liabilities

As at the date of this report, claims against nine exchange participants have been received by the SEHK, where the validity of these claims is under investigation by the SEHK and for those claims the SEHK has not sought the SFC's approval to increase the limit over \$8 million. Thus, these claims are subject to the normal \$8 million limit pursuant to Section 109 of the Securities Ordinance. We have not made any provision in these financial statements for any of these claims. Under these circumstances, the maximum liability of the Fund to these claims is \$72 million (2002: \$56 million).