

Unified Exchange Compensation 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 2005.

1. Establishment of the Unified Exchange Compensation Fund (the Fund)

Part X of the repealed Securities Ordinance (Chapter 333) established the Fund. However, when the Securities and Futures Ordinance (SFO) and its subsidiary legislation came into effect from 1 April 2003, a new single investor compensation fund (ICF) was formed to ultimately replace the Fund and the Commodity Exchange Compensation Fund. After reserving sufficient money in the Fund to meet claims against it and its other liabilities, the SFC will eventually transfer the remaining balance of the Fund to the ICF.

Part X of the repealed Securities Ordinance remains effective in respect of the operation of the Fund to the extent described in Section 74 of Schedule 10 of the SFO.

2. Financial results

The Committee presents the financial results which are set out in the financial statements on pages 124 to 134.

3. Members of the Committee

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

Mr. Peter Au-Yang	[appointed on 1 April 2005]
Mr. Mark Dickens, JP	[resigned on 31 March 2005]
Mr. Paul Chow Man Yiu, JP	[resigned on 31 March 2005]
Mr. Eddy C Fong, SBS, JP	[appointed on 1 April 2005]
Mr. Gerald Greiner	[appointed on 1 April 2005]
Mrs. Alexa Lam	
Mr. David M Roberts	
Mr. T Brian Stevenson, SBS	[resigned on 31 March 2005]

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, KPMG, being eligible, offer themselves for re-appointment.

On behalf of the Committee

Peter Au-Yang

Chairman

28 April 2005

[Auditors' Report To The Securities And 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 124 to 134 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 solely to you, as a body, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Institute of Certified Public 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, consistently applied and 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 as at 31 March 2005 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

28 April 2005

Unified Exchange Compensation Fund

[Income and Expenditure Account]

For the year ended 31 March 2005

(Expressed in Hong Kong dollars)

	Note	2005	2004
		\$'000	\$'000
Income			
Net investment income	3&5	955	8,687
Transaction levy	3	–	(4)
Compensation refund from claimants		–	31,810
Recoveries	3&7	14,673	107,899
Provision for compensation reversed	3&10	5,202	3,799
		20,830	152,191
Expenses			
Auditors' remuneration		37	37
Bank charges		29	110
Professional fees		23	138
Sundry expenses		2	54
		91	339
Surplus for the year		20,739	151,852
Accumulated deficit brought forward		(13,284)	(165,136)
Accumulated surplus/(deficit) carried forward		7,455	(13,284)

The notes on pages 128 to 134 form part of these financial statements.

[Balance Sheet]

At 31 March 2005

(Expressed in Hong Kong dollars)

	Note	2005 \$'000	2004 \$'000
Current assets			
Debt securities	6	–	160,985
Equity securities received under subrogation	7	7,793	7,251
Interest receivable		36	2,024
Fixed and call deposits with banks		47,028	167,407
Cash at bank		52	215
		54,909	337,882
Current liabilities			
Accounts payable and accrued charges	8	4,291	4,522
Provision for compensation	3&10	1,492	9,545
		5,783	14,067
Net current assets		49,126	323,815
Net assets		49,126	323,815
Representing:			
<u>Compensation fund</u>			
Contributions from the SEHK		46,100	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 surplus/(deficit)		7,455	(13,284)
		1,043,844	1,023,455
Contributions to Investor Compensation Fund	14	(994,718)	(699,640)
		49,126	323,815

Approved and authorised for issue by the Securities Compensation Fund Committee on behalf of the Securities and Futures Commission on 28 April 2005 and signed on its behalf by

Peter Au-Yang

Chairman

Alexa Lam

Committee Member

Eddy C Fong

Committee Member

The notes on pages 128 to 134 form part of these financial statements.

Unified Exchange Compensation Fund

[Statement of Changes in Equity]

For the year ended 31 March 2005
(Expressed in Hong Kong dollars)

	Note	2005 \$'000	2004 \$'000
Compensation Fund balance as at 1 April		323,815	871,603
Surplus for the year		20,739	151,852
Contributions refunded to the SEHK		(350)	–
Contributions to Investor Compensation Fund	14	(295,078)	(699,640)
Compensation Fund balance as at 31 March		49,126	323,815

The notes on pages 128 to 134 form part of these financial statements.

[Cash Flow Statement]

For the year ended 31 March 2005
(Expressed in Hong Kong dollars)

	2005	2004
	\$'000	\$'000
Cash flows from operating activities		
Surplus for the year	20,739	151,852
Net investment income	(955)	(8,687)
Decrease in levy receivable	–	5,607
Increase in equity securities received under subrogation	(542)	(7,251)
Decrease in provision for compensation	(8,053)	(21,083)
Decrease in accounts payable and accrued charges	(231)	(68)
Net cash from operating activities	10,958	120,370
Cash flows from investing activities		
Debt securities redeemed	90,500	220,000
Debt securities sold	67,763	166,824
Interest received	5,665	20,364
Net cash from investing activities	163,928	407,188
Cash flows from financing activities		
Contributions refunded to the SEHK	(350)	–
Contributions to Investor Compensation Fund	(295,078)	(699,640)
Net cash used in financing activities	(295,428)	(699,640)
Net decrease in cash and cash equivalents	(120,542)	(172,082)
Cash and cash equivalents at beginning of the year	167,622	339,704
Cash and cash equivalents at end of the year	47,080	167,622

Analysis of the balance of cash and cash equivalents:

	2005	2004
	\$'000	\$'000
Cash at bank	52	215
Fixed and call deposits with banks	47,028	167,407
	47,080	167,622

Unified Exchange Compensation Fund

[Notes to the Financial Statements]

For the year ended 31 March 2005
(Expressed in Hong Kong dollars)

1. 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 Stock Exchange of Hong Kong Limited (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.

After the Securities and Futures Ordinance (SFO) and its subsidiary legislation came into effect from 1 April 2003, a new single investor compensation fund (ICF) was formed to ultimately replace the Fund and the Commodity Exchange Compensation Fund. After allowing a sufficient sum of money in the Fund to meet claims against it and its other liabilities, the SFC will eventually transfer the remaining balance of the Fund into the ICF. 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 of the Securities Ordinance, under Section 74 of Schedule 10 of the SFO, Part X of the Securities Ordinance remains effective in respect of the operation of the Fund.

2. Money constituting the Fund

Before 1 April 2003, the SEHK was required to 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 (2004: 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 received before the SFO became effective from 1 April 2003.

3. Significant accounting policies

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

Basis of preparation

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 operations will cease as these are estimated to be immaterial.

Recognition of income

Net investment income Net investment income comprises (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 recognise recoveries pursuant to Section 118 of the Securities Ordinance as income to the Fund and recoveries re-distributed to claimants as expenses. We record recoveries received and re-distributed 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 compensation payments up to the amount of \$8,000,000 for each default to be charged to the contribution from the SEHK.

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3. Significant accounting policies (cont'd)

Investments

As we have prepared the financial statements on a break-up basis, we classify our investments in debt securities as current assets and 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 Fund'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.

We calculate the recoverable amount of the Fund's investments in debt securities and 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. The recoverable amount of other assets is the greater of their net selling price and value in use. In assessing value in use, we discount the estimated future cash flows to their present value at a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, we determine the recoverable amount for the cash-generating unit to which the asset belongs.

We reverse an impairment loss in respect of an asset 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. We reverse an impairment loss only to the extent that the asset's carrying amount does not exceed the carrying amount that we would have determined if we had not recognised any impairment loss.

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.

3. Significant accounting policies (cont'd)

Other payables

We state other payables at cost.

Contingent liabilities

Unless the probability of outflow of economic benefits is remote, we disclose obligations as contingent liabilities 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 to 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.

4. Taxation

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

5. Net investment income

	2005	2004
	\$'000	\$'000
Interest income from bank deposits and debt securities	3,110	14,463
Loss on revaluation of debt securities	(2,155)	(5,776)
Net investment income	955	8,687

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6. Debt securities

	2005	2004
	\$'000	\$'000
Maturing after one year		
In the second to third years – unlisted	–	–
After three years – unlisted	–	44,995
	–	44,995
Maturing within one year – unlisted	–	115,990
	–	160,985

During the year, the Fund sold debt securities of nominal value HK\$61 million to the ICF at market price.

7. Equity securities and recoveries

In relation to the share distribution from C.A. Pacific Securities Ltd. and C.A. Pacific Finance Ltd., the liquidators had advised SFC that shares were allocated to the Fund under its subrogation rights, subject to paying a processing fee to the liquidators. The Fund arranged to liquidate the shares as far as possible. The Fund recognised as recoveries the sale proceeds and the remaining shares at market value as of 31 March 2005 after deducting relevant processing fees and charges for collecting and selling the securities received.

8. Accounts payable and accrued charges

Accounts payable and accrued charges comprised mainly compensation payment re-established for those cheque payments that were not cleared over six months from the cheque issuing date and accrued auditors' remuneration.

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 46 trading rights having been transferred during the six months to 31 March 2005 (2004: 19 trading rights had been transferred during the six months to 31 March 2004). The SEHK also advised the SFC of two trading rights having been relinquished in July 2004. In respect of these two relinquished trading rights and five trading rights that had been relinquished in November 2003, the SFC had refunded deposits of total \$350,000 during the year to the SEHK.

10. Provision for compensation

	2005	2004
	\$'000	\$'000
Balance brought forward	9,545	30,628
Less : Amount paid during the year	(2,851)	(17,284)
Add : Net provision reversed	(5,202)	(3,799)
Balance carried forward	1,492	9,545

We maintain provision for claims in respect of three SEHK exchange participants for which the SEHK has published a notice calling for claims. The maximum liabilities of the Fund in respect of these three defaulted cases exceed the normal \$8 million limit provided by Section 109(3) of the Securities Ordinance.

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 2005, 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 \$71,562,000 to the Fund as follows:

	2005
	\$'000
Compensation paid up to the \$8 million limit as set out in Section 109(3) of the Securities Ordinance	99,091
Less : Recoveries received for compensation paid up to \$8 million	(27,554)
Add : Recoveries re-distributed to claimants	16,385
Less : Replenishments from the SEHK	(16,360)
Net amount the SFC may request the SEHK for replenishment	71,562

Under Section 74(3) of 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.

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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. Contributions to Investor Compensation Fund

When the SFO and its subsidiary legislation came into effect from 1 April 2003, a new single investor compensation fund (ICF) was formed to ultimately replace the Fund and the Commodity Exchange Compensation Fund. Under Section 74(2) of Schedule 10 of the SFO, the SFC may after 1 April 2003 pay into the ICF, which came into operation after 1 April 2003, such sum of money from the Fund as it considers appropriate. Total contributions paid into the ICF upto 31 March 2005 amounted to \$994,718,000.

15. Related party transactions

We have related party relationships with the ICF, 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 6, 9, 11, 12 and 14).

16. Financial instruments

The Fund had Hong Kong dollar deposits with banks only and, as a result, was not subject to significant interest rate, foreign exchange and credit risk.

17. Contingent liabilities

As at the date of this report, the SEHK has received claims against seven exchange participants. The validity of these claims is under investigation by the SEHK. 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 \$56 million (2004: \$64 million).