

# Investor Compensation Fund (the Fund)

## Report of the Investor Compensation Fund Committee (the Committee)

The members of the Committee present their first year annual report and the audited financial statements for the year ended 31 March 2004.

### 1. Establishment of the Fund

Part XII of the Securities and Futures Ordinance (Chapter 571) established the Fund on 1 April 2003.

### 2. Financial results

The Committee presents the financial results which are set out in the financial statements on pages 98 to 106.

### 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	(appointed on 1 April 2003)
Mrs Alexa Lam	(appointed on 1 April 2003)
Ms Anna H Y Wu, SBS, JP	(appointed on 1 April 2003)
Mr Frederick J Grede	(appointed on 1 April 2003 and resigned on 29 June 2003)
Mr Paul Chow Man Yiu, JP	(appointed on 30 June 2003)

### 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

KPMG were first appointed as auditors of the Fund in 2003 upon inception of the Fund. KPMG retired and, being eligible, offer themselves for re-appointment.

On behalf of the Committee

**Mark Dickens, JP**  
*Chairman*

4 May 2004

## **Auditors' Report To The Securities & Futures Commission (the SFC)**

We have audited the financial statements of the Investor Compensation Fund (the Fund) established under Part XII of the Securities and Futures Ordinance set out on pages 98 to 106 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 Securities and Futures 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 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, 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 2004 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

4 May 2004

## Investor Compensation Fund Financial Statements

### Income And Expenditure Account

For the year ended 31 March 2004

(Expressed in Hong Kong dollars)

	Note	2004 \$'000
<b>Income</b>		
Net investment income	3&5	4,643
Transaction levy from the SEHK	3&6	144,177
Contract levy from the HKFE	3&7	10,340
		159,160
<b>Expenses</b>		
ICC expenses	8	4,434
Auditors' remuneration		50
Bank charges		55
Professional fees		12
		4,551
<b>Surplus</b>		154,609
<b>Accumulated surplus brought forward</b>		–
<b>Accumulated surplus carried forward</b>		154,609

The notes on pages 102 to 106 form part of these financial statements.

## Balance Sheet

At 31 March 2004

(Expressed in Hong Kong dollars)

	Note	2004 \$'000
<b>Current assets</b>		
Debt securities	9	174,286
Interest receivable		1,656
Due from ICC		1,778
Levy receivable from the SEHK		16,415
Levy receivable from the HKFE		1,163
Fixed and call deposits with banks		766,964
Cash at bank		13
		962,275
<b>Current liabilities</b>		
Accounts payable and accrued charges		66
		962,209
<b>Net current assets</b>		
		962,209
<b>Net assets</b>		
Representing :		
<u>Compensation fund</u>		
Contributions from UECF	10	699,640
Contributions from CECF	10	107,960
Accumulated surplus		154,609
		962,209

Approved and authorised for issue by the Securities and Futures Commission (the SFC) on 4 May 2004 and signed on its behalf by

**Andrew L T Sheng**  
*Chairman of the SFC*

**Anna H Y Wu**  
*Non-executive Director of the SFC*

The notes on pages 102 to 106 form part of these financial statements.

## Investor Compensation Fund Financial Statements

### Statement of Changes in Equity

For the year ended 31 March 2004

(Expressed in Hong Kong dollars)

	Note	2004 \$'000
Compensation fund balance as at 1 April		–
Surplus for the year		154,609
Contributions from UECF	10	699,640
Contributions from CECF	10	107,960
Compensation fund balance as at 31 March		962,209

The notes on pages 102 to 106 form part of these financial statements.

## Cash Flow Statement

For the year ended 31 March 2004  
(Expressed in Hong Kong dollars)

	<b>2004 \$'000</b>
<b>Cash flows from operating activities</b>	
Surplus for the year	154,609
Net investment income	(4,643)
Increase in levies receivable	(17,578)
Increase in accounts receivable	(1,778)
Increase in accounts payable and accrued charges	66
Net cash from operating activities	130,676
<b>Cash flows from investing activities</b>	
Purchase of debt securities	(218,378)
Sale or maturity of debt securities	43,000
Interest received	4,079
Net cash used in investing activities	(171,299)
<b>Cash flows from financing activities</b>	
Contributions received from UECF	699,640
Contributions received from CECF	107,960
Net cash from financing activities	807,600
<b>Net increase in cash and cash equivalents</b>	766,977
<b>Cash and cash equivalents at beginning of the year</b>	–
<b>Cash and cash equivalents at end of the year</b>	766,977

### Analysis of the balance of cash and cash equivalents :

	<b>2004 \$'000</b>
Cash at bank	13
Fixed and call deposits with banks	766,964
	766,977

## Notes to the Financial Statements

For the year ended 31 March 2004  
(Expressed in Hong Kong dollars)

### 1. Purpose, limitation and principal activity

The Securities and Futures Ordinance (SFO) provides for the establishment of the Investor Compensation Fund (the Fund) to compensate investors who suffer a loss due to the default of an intermediary in relation to trading of products on Hong Kong Exchanges and Clearing Limited. The defaulting intermediary must be licensed or registered with the Securities and Futures Commission (SFC) for dealing in securities, futures contracts or securities margin financing.

The SFC is primarily responsible for the administration and management of the Fund in accordance with Section 238 of the SFO, but has transferred some functions to the Investor Compensation Company Ltd. (ICC) under Section 80 of the SFO. ICC is thus responsible for receipt, determination and payment of valid claims against the Fund in respect of defaults of intermediaries occurring on or after 1 April 2003. Upon making payment to a claimant, the SFC is subrogated to the claimant's right against the defaulter.

Pursuant to Section 244 of the SFO, the Chief Executive in Council has by order set the maximum amount of compensation at \$150,000 per claimant for a single default in relation to securities traded at the Stock Exchange of Hong Kong Limited (SEHK) or futures contracts traded at the Hong Kong Futures Exchange Limited (HKFE).

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 & Futures (Investor Compensation-Claims) Rules. The SFC would pay unpaid claim amounts when funds became available in the Fund.

### 2. Money constituting the Fund

The Fund mainly consists of the amounts paid from the two existing compensation funds, the Unified Exchange Compensation Fund (UECF) and the Commodity Exchange Compensation Fund (CECF). The SFC will also pay into the Fund any remaining balance in the Securities Dealers' Deposits Fund and the Commodities Dealers' Deposits Fund after repaying the dealers' deposits and any money due to the registered dealers in accordance with Section 76 (11) of Schedule 10 of the SFO.

Other sources of money for the Fund include the levies chargeable on securities traded on the SEHK and futures contracts traded on the HKFE, and returns earned on the investment of the Fund.

### 3. Significant accounting policies

#### Basis of preparation

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.

#### 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 / Contract levy** We record levy as income at a fixed rate on every leviable SEHK and HKFE transaction on an accrual basis.

### **3. Significant accounting policies (Cont'd)**

#### **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 on translation in the income and expenditure account.

#### **Investments**

We classify our investments as current assets and state these investments 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 published closing prices or 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.

##### **(i) 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.

##### **(ii) 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 for which the SFC or ICC has published a notice calling for claims pursuant to Section 3 of the Securities & Futures (Investor Compensation-Claims) Rules. The provision covers all such claims received up to the date on which the financial statements are approved by the SFC.

The maximum liability of the Fund to claims for each default case is set at \$150,000 per claimant.

#### **Other payables**

We state other payables at cost.

## Investor Compensation Fund Financial Statements

### 3. Significant accounting policies (Cont'd)

#### Contingent liability

Unless the probability of outflow of economic benefits is remote, we disclose obligations 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 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.

### 4. Taxation

The interest and profits on investment earned by the Fund are not subject to profits tax under Section 14 of the Inland Revenue Ordinance.

### 5. Net investment income

	<b>2004 \$'000</b>
Interest Income from bank deposits and debt securities	4,254
Unrealised gain on revaluation of debt securities	389
Net investment income	<b>4,643</b>

### 6. Transaction levy from the SEHK

From 1 April 2003, the Fund received a transaction levy chargeable under the SFO at 0.002% of every leviable SEHK transaction.

### 7. Contract levy from the HKFE

From 1 April 2003, the Fund received a contract levy chargeable under the SFO at \$0.5 per leviable HKFE transaction except for Mini-Hang Seng Index Futures Contracts, Mini-Hang Seng Index Options Contracts, Stock futures contracts and Options on Stock futures contracts, all of which are chargeable at \$0.1 per transaction.



### 12. 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 pooled funds, fixed rate dated securities or in bank deposits. Other than those holdings of pooled funds and fixed rate dated securities issued by the US Treasury and multilateral agencies with AAA credit rating, the policy 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 have US dollar foreign exchange exposure. 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.

### 13. Contingent liabilities

As at the date of this report, the Fund has received claims against three intermediaries. The validity of these claims is under investigation. We have not made any provision for these claims. The maximum contingent liability of the Fund to these claims is \$450,000.