

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 2004.

1. Establishment of the Fund

Part X of the 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 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 109 to 119.

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

(membership ceased on 16 April 2003)

Mr Paul Chow Man Yiu, JP

(appointed on 19 May 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, JP

Chairman

30 April 2004

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 109 to 119 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 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

30 April 2004

Income and Expenditure Account

For the year ended 31 March 2004

(Expressed in Hong Kong dollars)

	Note	2004 \$'000	2003 \$'000
Income			
Net investment income	3&5	8,687	40,541
Transaction levy	3&6	(4)	68,560
Compensation refund from claimants	7	31,810	–
Recoveries	3&9	107,899	720
		148,392	109,821
Expenses			
Provision for compensation (reversed) / made	3&11	(3,799)	15,591
Recoveries re-distributed to claimants	3	–	1,868
Auditors' remuneration		37	41
Bank charges		110	253
Exchange difference		–	11
Professional fees		138	196
Sundry expenses		54	5
		(3,460)	17,965
Surplus for the year		151,852	91,856
Accumulated deficit brought forward		(165,136)	(256,992)
Accumulated deficit carried forward		(13,284)	(165,136)

The notes on pages 113 to 119 form part of these financial statements.

Unified Exchange Compensation Fund Financial Statements

Balance Sheet

At 31 March 2004

(Expressed in Hong Kong dollars)

	Note	2004 \$'000	2003 \$'000
Current assets			
Debt securities	8	160,985	555,930
Equity securities received under subrogation	9	7,251	–
Interest receivable		2,024	5,580
Levy receivable		–	5,607
Fixed and call deposits with banks		167,407	339,687
Cash at bank		215	17
		337,882	906,821
Current liabilities			
Accounts payable and accrued charges		4,522	4,590
Provision for compensation	3&11	9,545	30,628
		14,067	35,218
Net current assets			
		323,815	871,603
Net assets			
		323,815	871,603
Representing :			
<u>Compensation fund</u>			
Contributions from the SEHK	10	46,450	46,450
Excess transaction levy from the SEHK	13	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	14	3,002	3,002
Accumulated deficit		(13,284)	(165,136)
		1,023,455	871,603
Contributions to Investor Compensation Fund	15	(699,640)	–
		323,815	871,603

Approved and authorised for issue by the Securities Compensation Fund Committee on behalf of the Securities and Futures Commission on 30 April 2004 and signed on its behalf by

Mark Dickens
Chairman

Alexa Lam
Committee Member

T Brian Stevenson
Committee Member

The notes on pages 113 to 119 form part of these financial statements.

Statement of Changes in Equity

For the year ended 31 March 2004

(Expressed in Hong Kong dollars)

	Note	2004 \$'000	2003 \$'000
Compensation fund balance as at 1 April		871,603	779,747
Surplus for the year		151,852	91,856
Contributions to Investor Compensation Fund	15	(699,640)	–
Compensation fund balance as at 31 March		323,815	871,603

The notes on pages 113 to 119 form part of these financial statements.

Unified Exchange Compensation Fund Financial Statements

Cash Flow Statement

For the year ended 31 March 2004

(Expressed in Hong Kong dollars)

	2004 \$'000	2003 \$'000
Cash flows from operating activities		
Surplus for the year	151,852	91,856
Net investment income	(8,687)	(40,541)
Decrease in levy receivable	5,607	641
Increase in equity securities received under subrogation	(7,251)	–
Decrease in provision for compensation	(21,083)	(9,985)
(Decrease) / Increase in accounts payable and accrued charges	(68)	1,866
Net cash from operating activities	120,370	43,837
Cash flows from investing activities		
Debt securities redeemed	220,000	391,500
Debt securities sold	166,824	–
Debt securities bought	–	(219,563)
Interest received	20,364	43,996
Net cash from investing activities	407,188	215,933
Cash flows from financing activities		
Additional contribution from the SFC	–	30,000
Contributions to Investor Compensation Fund	(699,640)	–
Net cash (used in) / from financing activities	(699,640)	30,000
Net (decrease) / increase in cash and cash equivalents	(172,082)	289,770
Cash and cash equivalents at beginning of the year	339,704	49,934
Cash and cash equivalents at end of the year	167,622	339,704

Analysis of the balance of cash and cash equivalents :

	2004 \$'000	2003 \$'000
Cash at bank	215	17
Fixed and call deposits with banks	167,407	339,687
	167,622	339,704

Notes to the Financial Statements

For the year ended 31 March 2004
(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 (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.

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 (2003 : 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 12; special levy surplus detailed in note 14; and transaction levy detailed in note 6.

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 leviabie 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.

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

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.

3. Significant accounting policies (cont'd)

(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 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 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 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.

Unified Exchange Compensation Fund Financial Statements

4. Taxation

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

5. Net investment income

	2004 \$'000	2003 \$'000
Interest income from bank deposits and debt securities	14,463	34,209
Unrealised (loss) / gain on revaluation of debt securities	(5,776)	6,332
Net investment income	8,687	40,541

6. Transaction levy

From 1 September 2001 to 31 March 2003, the Fund received a transaction levy chargeable at 0.002% of every leviable SEHK transaction. After the SFO came into effect on 1 April 2003, transaction levy was paid into the ICF. No transaction levy was received by the Fund for the year.

7. Compensation refund from claimants

The joint liquidators of C.A. Pacific Securities Ltd. (In Liquidation) and C.A. Pacific Finance Ltd. (In Liquidation) have obtained the court's approval to distribute shares to clients, starting from 30 June, 2003. The clients could either keep the compensation payment paid by the Fund or return the compensation payment before 29 October 2003 to the Fund to get back the shares allotted to them from the liquidators, subject to paying a processing fee to the liquidators. If a client elected to retain the compensation payment, the liquidators would allocate shares between the client and the Fund proportionally to the client's loss and the amount of the compensation payment as the Fund is subrogated to the client's rights to the extent of the compensation payments.

During the year, the Fund received shares from the liquidators as a result of those clients who chose to keep the compensation payment, which is detailed in note 9. Up to 29 October 2003, the Fund also received repayments of compensation of \$31,810,000 from those clients who chose to take the allocated shares. This amount has been recognised in the income and expenditure account.

Unified Exchange Compensation Fund Financial Statements

11. Provision for compensation

	2004 \$'000	2003 \$'000
Balance brought forward	30,628	40,613
Less : Amount paid during the year	(17,284)	(25,576)
Unused provision reversed during the year	(3,799)	(4,443)
Additional provision made for the year	–	20,034
Add : Net provision (reversed)/made	(3,799)	15,591
Balance carried forward	9,545	30,628

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

12. 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 2004, 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 \$72,729,000 to the Fund as follows :

	2004 \$'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	(26,387)
Add : Recoveries re-distributed to claimants	16,385
Less : Replenishments from the SEHK	(16,360)
Net amount SFC may request SEHK for replenishment	72,729

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.

13. 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.

14. 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.

15. 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. During the year, the SFC paid \$699,640,000 into the ICF from the Fund.

16. 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, 8, 10, 12, 13 and 15).

17. 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

All our debt securities are denominated in Hong Kong dollars and, as a result, the Fund was not exposed to 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.

18. Contingent liabilities

As at the date of this report, claims against eight 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 \$64 million (2003 : \$72 million).