

Investor Compensation Fund (the Fund)

Report of the Investor 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 2006.

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 109 to 120.

3. Members of the Committee

The members of the Committee during the year ended 31 March 2006 and up to the date of this report were: -

Mr. Martin Wheatley (Chairman)	[appointed on 21 June 2005]
Mr. Gerald Greiner	
Mrs. Alexa Lam	
Ms. Anna H.Y. Wu, SBS, JP	
Mr. Eddy C. Fong, SBS, JP	[appointed on 21 June 2005]
Mr. Peter Au-Yang	[appointed on 1 April 2005 and resigned on 20 June 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

Martin Wheatley

Chairman

4 May 2006

Investor Compensation Fund

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 109 to 120 which have been prepared in accordance with International Financial Reporting Standards.

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 Hong Kong Standards on Auditing 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 2006 and of its surplus and cash flows for the year then ended, and have been properly prepared in accordance with International Financial Reporting Standards.

KPMG

Certified Public Accountants

Hong Kong

4 May 2006

Income and Expenditure Account

For the year ended 31 March 2006
(Expressed in Hong Kong dollars)

	Note	2006 \$'000	2005 \$'000
Income			
Net investment income	3&5	73,212	28,668
Levy from the SEHK	3&6	144,983	163,914
Levy from the HKFE	3&6	11,464	13,279
		229,659	205,861
Expenses			
ICC expenses	7	3,263	4,066
Auditors' remuneration		65	55
Bank charges		1,125	947
Professional fees		2,469	1,539
Exchange difference		4,687	383
Sundry expenses		1	1
		11,610	6,991
		218,049	198,870
Surplus			
Accumulated surplus brought forward		353,479	154,609
Accumulated surplus carried forward		571,528	353,479

The notes on pages 113 to 120 form part of these financial statements.

Investor Compensation Fund

Balance Sheet

At 31 March 2006

(Expressed in Hong Kong dollars)

	Note	2006 \$'000	2005 \$'000
Current assets			
Financial assets designated at fair value through profit or loss			
– Debt securities	8	1,357,440	1,182,665
– Equity securities	8	145,608	122,409
Other receivables		–	384
Interest receivable		17,848	13,731
Due from ICC		1,726	1,111
Levy receivable from the SEHK		–	16,434
Levy receivable from the HKFE		–	1,283
Fixed and call deposits with banks	9	152,341	81,663
Cash at bank	9	9	37,295
		1,674,972	1,456,975
Current liabilities			
Accounts payable and accrued charges		766	818
		1,674,206	1,456,157
Net current assets			
		1,674,206	1,456,157
Net assets			
		1,674,206	1,456,157
Representing:			
<u>Compensation fund</u>			
Contributions from UECF	10	994,718	994,718
Contributions from CECF	10	107,960	107,960
Accumulated surplus		571,528	353,479
		1,674,206	1,456,157

Approved and authorised for issue by the Securities and Futures Commission (the SFC) on 4 May 2006 and signed on its behalf by

Martin Wheatley
Chairman of the SFC

Eddy C. Fong
Non-executive Director of the SFC

The notes on pages 113 to 120 form part of these financial statements.

Statement of Changes in Equity

For the year ended 31 March 2006
(Expressed in Hong Kong dollars)

	2006	2005
	\$'000	\$'000
Compensation Fund balance as at 1 April	1,456,157	962,209
Surplus for the year	218,049	198,870
Contributions from UECF	–	295,078
Compensation Fund balance as at 31 March	1,674,206	1,456,157

The notes on pages 113 to 120 form part of these financial statements.

Investor Compensation Fund

Cash Flow Statement

For the year ended 31 March 2006

(Expressed in Hong Kong dollars)

	2006	2005
	\$'000	\$'000
Cash flows from operating activities		
Surplus for the year	218,049	198,870
Net investment income	(73,212)	(28,668)
Exchange difference	4,687	383
Decrease/(increase) in levies receivable	17,717	(139)
(Increase)/decrease in amount due from ICC	(615)	667
(Decrease)/increase in accounts payable and accrued charges	(52)	752
Net cash from operating activities	166,574	171,865
Cash flows from investing activities		
Purchase of debt securities	(3,331,795)	(2,729,479)
Purchase of equity securities	–	(99,990)
Sale or maturity of debt securities	3,146,281	1,692,647
Sale of equity securities	641	278
Interest received	51,691	21,582
Net cash used in investing activities	(133,182)	(1,114,962)
Cash flows from financing activities		
Contributions received from UECF	–	295,078
Net cash from financing activities	–	295,078
Net increase/(decrease) in cash and cash equivalents	33,392	(648,019)
Cash and cash equivalents at beginning of the year	118,958	766,977
Cash and cash equivalents at end of the year	152,350	118,958

Analysis of the balance of cash and cash equivalents:

	2006	2005
	\$'000	\$'000
Fixed and call deposits with banks	152,341	81,663
Cash at bank	9	37,295
	152,350	118,958

Notes to the Financial Statements

For the year ended 31 March 2006
(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

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

Investor Compensation Fund

3. Significant accounting policies (cont'd)

Basis of preparation

We have prepared these financial statements using the historical cost basis as the measurement basis, except that we state financial instruments classified as designated at fair value through profit or loss at their fair value (see accounting policy stated below).

We prepare the financial statements in conformity with IFRSs which requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets, liabilities, income and expenses. We make estimates and associated assumptions based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

We review estimates and underlying assumptions on an ongoing basis. We recognise revisions to accounting estimates in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Recognition of income

We recognise income in the income and expenditure account provided it is probable that the economic benefits will flow to the Fund and we can measure reliably the revenue and costs. We record our income as follows:

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 equity securities and (iii) realised gain or loss on redemption and disposal of debt securities and equity securities. We record interest income as it accrues using the effective interest method.

Levy We record levy as income at a fixed rate on every leviable SEHK transaction and HKFE contract on an accrual basis.

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.

3. Significant accounting policies (cont'd)

Financial Instruments

(i) Initial recognition

We classify the financial instruments into different categories at inception, depending on the purpose for which the assets were acquired or the liabilities were incurred. The categories are: fair value through profit or loss, loans and receivables, held-to-maturity investments, available-for-sale financial assets and other financial liabilities.

We measure financial instruments at fair value, which normally will be equal to the transaction price, plus, in case of a financial asset or financial liability not held at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability. We charge transaction costs on financial assets and financial liabilities at fair value through profit or loss to expense immediately.

We recognise the financial assets and financial liabilities on the date it becomes a party to the contractual provisions of the instrument. We recognise regular purchase or sale of financial assets using settlement date accounting. From this date, we record in the Fund's books any gains and losses arising from changes in fair value of the financial assets or financial liabilities.

The Fund's financial instruments mainly consists of debt and equity securities designated at fair value through profit or loss. We state financial assets and liabilities under this category at fair value and recognise changes in the fair value in the income and expenditure account in the period in which they arise. Upon disposal or repurchase, the difference between the net sale proceeds or the net payment and the carrying value is included in the income and expenditure account.

(ii) Fair value measurement principles

We determine the fair value of financial instruments based on their quoted market prices on a recognised stock exchange or a price from a broker/dealer for non-exchange-traded financial instruments at the balance sheet date without any deduction for estimated future selling costs. Financial assets are priced at current bid prices, while financial liabilities are priced at current asking prices.

(iii) Derecognition

We derecognise a financial asset when the contractual rights to receive the cash flows from the financial asset expire, or where the financial asset together with substantially all the risks and rewards of ownership, have been transferred.

We derecognise a financial liability when the obligation specified in the contract is discharged, cancelled or expires.

(iv) Offsetting

We offset the financial assets and financial liabilities and report the net amount in the balance sheet where there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

Investor Compensation Fund

3. Significant accounting policies (cont'd)

Impairment

(i) Recognition of impairment loss

We review the carrying amounts of the Fund's assets at each balance sheet date to determine whether there is any objective evidence of impairment. If any such evidence exists, we estimate the asset's recoverable amount. We recognise in the income and expenditure account the difference between the asset's carrying amount and the recoverable amount as an impairment loss whenever the carrying amount of an asset exceeds its recoverable amount.

(ii) Calculation of impairment loss

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.

(iii) Reversals of impairment loss

We reverse an impairment loss in respect of an asset in a subsequent period if the circumstances and events that have objectively linked 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.

Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and on hand, demand deposits with banks and other financial institutions, and short term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value, having been within three months of maturity at acquisition.

Other receivables

We state other receivables initially at fair value and thereafter at amortised 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 initially at fair value and thereafter at amortised cost unless the effect of discounting would be immaterial in which case we state them at cost.

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 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 (being members of key management personnel, and/or their close family members) or other entities and include entities which are under the significant influence of related parties of the Fund where those parties are individuals.

Impact of the newly implemented IFRSs

In December 2003 and March 2004, the IASB approved amendments to a number of existing standards as a result of the Improvements project and issued several new standards. The objectives of the Improvements project were to reduce or eliminate alternatives, redundancies and conflicts with the standards, to deal with some convergence issues and to make other improvements.

As a result, we adopted the newly implemented IFRSs for the financial period starting from 1 April 2005. However, the adoption of these newly implemented IFRSs do not have a significant impact on the financial statements of the Fund.

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

	2006	2005
	\$'000	\$'000
Interest income from bank deposits and debt securities	47,985	20,080
Realised (loss)/gain on disposal of equity securities	(1)	44
Realised gain/(loss) on redemption/disposal of debt securities	5,578	(2,252)
Gain on revaluation of equity securities	24,467	22,632
Loss on revaluation of debt securities	(4,817)	(11,836)
Net investment income	73,212	28,668

Investor Compensation Fund

6. Levy from the SEHK/HKFE

From 1 April 2003, the Fund received levy chargeable on leviable SEHK transactions and leviable HKFE contracts pursuant to Part 2 and Part 3 of the Securities and Futures (Investor Compensation – Levy) Rules.

After the Securities and Futures (Investor Compensation – Levy) (Amendment) Rules 2005 came into effect on 28 October 2005, a levy suspension and re-instatement mechanism is established whereby the investor compensation levies can be suspended when the net asset value of the Fund exceeds \$1.4 billion, and subsequently reinstated when the net asset value of the Fund falls below \$1 billion. Pursuant to the Securities and Futures (Investor Compensation Levy) (Amendment) Rules 2005 and the Gazette on 11 November 2005, no person is required to pay any levy to the Fund in respect of a sale and purchase of securities and futures contract with effect from 19 December 2005.

7. ICC expenses

The SFC formed the Investor Compensation Company Limited (ICC) in September 2002 to perform functions on behalf of the Fund in relation to the compensation to investors and other functions under Part III and Part XII of the SFO. The Fund is responsible for funding the establishment and operation of ICC. For the year ended 31 March 2006, ICC incurred cost of \$3,263,000 for its operations (2005: \$4,066,000).

8. Financial assets designated at fair value through profit or loss

	2006 \$'000	2005 \$'000
(a) Debt securities		
(i) Listing status		
Listed – outside Hong Kong	385,850	654,186
Unlisted	971,590	528,479
	1,357,440	1,182,665
(ii) Maturity profile		
– Within one year	695,808	580,646
– After one year but within two years	442,602	295,638
– After two years but within five years	156,279	254,587
– After five years	62,751	51,794
	1,357,440	1,182,665
(iii) The weighted average effective interest rate of debt securities at 31 March 2006 was 4.88% (2005: 3.78%).		
(b) Equity securities		
Unlisted	145,608	122,409

9. Deposits with banks and cash at bank

The effective interest rate of deposits with banks and cash at bank at 31 March 2006, ranged from 3.8% to 4.72% (2005: 1.98% to 2.8%). The balances matured within one year at both 31 March 2006 and 31 March 2005.

10. Contributions from UECF and CECF

Under Sections 74(2) and 75(2) of Schedule 10 of the SFO, the SFC may pay into the Fund such sum of money from the UECF and the CECF as it considers appropriate after 1 April 2003. Upto 31 March 2006, the SFC paid \$994,718,000 (2005: \$994,718,000) and \$107,960,000 (2005: \$ 107,960,000) into the Fund from the UECF and the CECF respectively.

11. Related party transactions

We have related party relationships with the SFC, the ICC, the SEHK, the HKFE, the UECF and the CECF. During the year, there were no significant related party transactions other than those disclosed in the financial statements (refer to notes 6, 7 & 10).

12. Financial instruments

Financial assets of the Fund comprise debt securities and pooled fund. The underlying investments of the pooled fund mainly include equity 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 Fund's total investments respectively. During the year, the Fund complied with the above investment policy and, as a result, was not exposed to significant credit risk.

(ii) Interest rate risk

The Fund's interest bearing assets mainly comprises debt securities and bank deposits. It limits its interest rate risks by investing mainly in fixed rate dated securities. The Fund's bank deposits expose only to short term bank deposit interest repricing risk. We considered that the Fund was not exposed to significant interest rate risk. In respect of its interest bearing assets, their effective interest rates and maturity profile are disclosed in the respective notes to the financial statements.

(iii) 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.

(iv) 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 and equity securities. Such risk will be reflected in the price and the carrying value of the financial assets concerned.

Investor Compensation Fund

13. Contingent liabilities

As at the date of this report, the Fund has six outstanding claims in respect of four 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 \$900,000 (As at 31 March 2005: \$900,000).

14. Non-adjusting post balance sheet event

Pursuant to Section 75(9) of Schedule 10 of the SFO, after all claims against the CECF have been disposed of and all deposits paid to the CECF under Section 82 of the repealed CTO have been reimbursed to the HKFE, the SFC shall pay the remaining balance of the CECF to the Fund. Section 75(11) of Schedule 10 of the SFO also stipulates that where the SFC is unable to locate a successful claimant within three years from the date their claim was allowed, the money must be paid into the Fund. The three year period started to run from 1 April 2003 and expired on 31 March 2006. As at 31 March 2006, there was an unclaimed balance of \$158,013 payable to 10 claimants. Such balance should be paid into the Fund after the lapse of the three year time barred period on 31 March 2006.

On 3 April 2006, \$932,010 was transferred into the Fund from the CECF, leaving a cash balance of \$51,583 in CECF which will be used to settle all outstanding liabilities of the CECF before winding up.

15. Possible impact of amendments, new standards and interpretations issued but not yet effective for the annual accounting period ended 31 March 2006

Up to the date of issue of these financial statement, the IASB has issued a number of amendments, new standards and interpretations which are not yet effective for the accounting period ended 31 March 2006 and which have not been adopted in these financial statements.

Of these developments, the following relate to matters that may be relevant to the Fund's operations and financial statements:

	Effective for accounting periods beginning on or after
IFRS 7, Financial instruments: disclosures	1 January 2007

We are in the process of making an assessment of what the impact of the new standard is expected to be in the period of initial application. So far it has concluded that while the adoption of them may result in new or amended disclosures, it is unlikely to have a significant impact on the Fund's results of operations and financial position.