

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 2006.

1. Establishment of 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Part X of the repealed Securities Ordinance (Chapter 333) established the Fund.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Part X of the repealed Securities Ordinance remains effective in respect of the operation of the Fund to the extent described in Section 74 of Schedule 10 of the SFO.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 123 to 133.

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]
Mrs. Alexa Lam	
Mr. Eddy C. Fong, SBS, JP	[appointed on 1 April 2005]
Mr. Gerald Greiner	[appointed on 1 April 2005]
Mr. Roger Lee	[appointed on 1 April 2006]
Mr. Peter Au-Yang	[appointed on 1 April 2005 and resigned on 20 June 2005]
Mr. David M. Roberts	[resigned on 31 March 2006]

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

26 April 2006

Unified Exchange Compensation Fund

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the financial statements of the Unified Exchange Compensation Fund (the Fund) established under Section 99 of the repealed Hong Kong Securities Ordinance set out on pages 123 to 133 which have been prepared in accordance with International Financial Reporting Standards.

Respective responsibilities of the SFC and auditors

The directors of the SFC are responsible for preparing financial statements of the Fund that 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

26 April 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	1,792	955
Recoveries	3&6	2,384	14,673
Replenishments from the SEHK		1	–
Provision for compensation reversed	3&9	–	5,202
		4,177	20,830
Expenses			
Provision for compensation made	9	2,005	–
Auditors' remuneration		30	37
Bank charges		1	29
Professional fees		10	23
Sundry expenses		2	2
		2,048	91
Surplus for the year		2,129	20,739
Accumulated surplus/(deficit) brought forward		7,455	(13,284)
Accumulated surplus carried forward		9,584	7,455

The notes on pages 127 to 133 form part of these financial statements.

Unified Exchange Compensation Fund

Balance Sheet

At 31 March 2006

(Expressed in Hong Kong dollars)

	Note	2006 \$'000	2005 \$'000
Current assets			
Equity securities received under subrogation	6	721	7,793
Interest receivable		91	36
Fixed and call deposits with banks		57,236	47,028
Cash at bank		14	52
		58,062	54,909
Current liabilities			
Accounts payable and accrued charges	7	4,254	4,291
Provision for compensation	3&9	2,553	1,492
		6,807	5,783
Net current assets			
		51,255	49,126
Net assets			
		51,255	49,126
Representing:			
<u>Compensation fund</u>			
Contributions from the SEHK		46,100	46,100
Excess transaction levy from the SEHK	11	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	12	3,002	3,002
Accumulated surplus		9,584	7,455
		1,045,973	1,043,844
Contributions to Investor Compensation Fund	13	(994,718)	(994,718)
		51,255	49,126

Approved and authorised for issue by the Securities Compensation Fund Committee on behalf of the Securities and Futures Commission on 26 April 2006 and signed on its behalf by

Martin Wheatley
Chairman

Alexa Lam
Committee Member

Eddy C. Fong
Committee Member

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	49,126	323,815
Surplus for the year	2,129	20,739
Contributions refunded to the SEHK	–	(350)
Contributions to Investor Compensation Fund	–	(295,078)
Compensation Fund balance as at 31 March	51,255	49,126

The notes on pages 127 to 133 form part of these financial statements.

Unified Exchange 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	2,129	20,739
Net investment income	(1,792)	(955)
Decrease/(increase) in equity securities received under subrogation	7,072	(542)
Increase/(decrease) in provision for compensation	1,061	(8,053)
Decrease in accounts payable and accrued charges	(37)	(231)
Net cash from operating activities	8,433	10,958
Cash flows from investing activities		
Debt securities redeemed	–	90,500
Debt securities sold	–	67,763
Interest received	1,737	5,665
Net cash from investing activities	1,737	163,928
Cash flows from financing activities		
Contributions refunded to the SEHK	–	(350)
Contributions to Investor Compensation Fund	–	(295,078)
Net cash used in financing activities	–	(295,428)
Net increase/(decrease) in cash and cash equivalents	10,170	(120,542)
Cash and cash equivalents at beginning of the year	47,080	167,622
Cash and cash equivalents at end of the year	57,250	47,080

Analysis of the balance of cash and cash equivalents:

	2006	2005
	\$'000	\$'000
Fixed and call deposits with banks	57,236	47,028
Cash at bank	14	52
	57,250	47,080

Notes to the Financial Statements

For the year ended 31 March 2006
(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 repealed 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 repealed 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 repealed 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 repealed Securities Ordinance, under Section 74 of Schedule 10 of the SFO, Part X of the repealed 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 repealed 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 (2005: nil).

Unified Exchange Compensation Fund

2. Money constituting the Fund (cont'd)

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 10; special levy surplus detailed in note 12; 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 ("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.

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.

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

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 as it accrues using the effective interest method.

Recoveries We recognise recoveries pursuant to Section 118 of the repealed Securities Ordinance as income to the Fund and recoveries re-distributed to claimants as expenses. We record recoveries received and re-distributed when and only when we can virtually certain that the recoveries will be received and paid.

Replenishments by the SEHK We record replenishments from the SEHK pursuant to Section 107 of the repealed 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.

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.

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 repealed 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 repealed 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.

Accounts payables and accrued charges

We state payables and accrued charges initially at fair value and thereafter state them at amortised cost unless the effect of discounting would be immaterial, in which case they are stated at cost.

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3. Significant accounting policies (cont'd)

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 (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

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

5. Net investment income

	2006 \$'000	2005 \$'000
Interest income from bank deposits and debt securities	1,792	3,110
Loss on revaluation of debt securities	–	(2,155)
Net investment income	1,792	955

6. 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 2006 after deducting relevant processing fees and charges for collecting and selling the securities received.

According to the repealed Securities Ordinance, the Fund is under an obligation to refund any excess amount representing the excess of the sale proceeds of recovered assets over the compensation amount. We will proceed to make the refund once the verification process is completed.

7. 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.

8. 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 repealed 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 8 trading rights having been transferred during the six months to 31 March 2006 (2005: 46 trading rights had been transferred during the six months to 31 March 2005).

9. Provision for compensation

	2006	2005
	\$'000	\$'000
Balance brought forward	1,492	9,545
Less: Amount paid during the year	(944)	(2,851)
Add: Net provision made/(reversed)	2,005	(5,202)
Balance carried forward	2,553	1,492

We maintain provision for claims in respect of two SEHK exchange participants for which the SEHK has published a notice calling for claims.

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10. Replenishments from the SEHK

Under Section 107 of the repealed 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 2006, the SEHK has replenished \$16,361,000 to the Fund. In compliance with Section 107 of the repealed Securities Ordinance, if no further recoveries were to be collected, the SFC may require the SEHK to further replenish \$70,096,000 to the Fund as follows:

	2006 \$'000	2005 \$'000
Compensation paid up to the \$8 million limit as set out in Section 109(3) of the repealed Securities Ordinance	99,091	99,091
Less: Recoveries received for compensation paid up to \$8 million	(29,019)	(27,554)
Add: Recoveries re-distributed to claimants	16,385	16,385
Less: Replenishments from the SEHK	(16,361)	(16,360)
Net amount the SFC may request the SEHK for replenishment	70,096	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.

11. 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.

12. 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.

13. 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 2006 amounted to \$994,718,000.

14. 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 8, 10, 11 and 13).

15. 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.

16. Contingent liabilities

As at the date of this report, the SEHK has received claims against three 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 repealed 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 \$24 million (2005: \$56 million).

17. 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 these amendments, new standards and new interpretations 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.