

# 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 2007.

### 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 79 to 91.

### 3. Members of the Committee

The members of the Committee during the year ended 31 March 2007 and up to the date of this report were:

Mr. Keith Lui (Chairman)	[appointed on 19 September 2006]
Mr. Gerald Greiner	
Mrs. Alexa Lam	
Mr. Kenneth H W Kwok, BBS, SC	[appointed on 16 January 2007]
Mr. Eddy C Fong, SBS, JP	[resigned on 15 January 2007]
Mr. Martin Wheatley	[resigned on 18 September 2006]
Ms. Anna H Y Wu, SBS, JP	[resigned on 11 August 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

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

On behalf of the Committee

**Keith Lui**

*Chairman*

4 May 2007

## Investor Compensation Fund

### Independent Auditor's Report to the Securities & Futures Commission (the SFC)

We have audited the financial statements of Investor Compensation Fund (the Fund) established under Part XII of the Securities and Futures Ordinance set out on pages 79 to 91 which comprise the balance sheet as at 31 March 2007 and the income and expenditure account, the statement of changes in equity and the cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

#### The SFC's responsibility for the financial statements

The Securities and Futures Ordinance requires the directors of 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 and in accordance with International Financial Reporting Standards promulgated by the International Accounting Standards Board. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

#### Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. This report is made solely to you and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit 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 2007 and of its result and cash flows for the year then ended in accordance with International Financial Reporting Standards.

#### **KPMG**

*Certified Public Accountants*

8th Floor, Prince's Building

10 Chater Road

Central, Hong Kong

4 May 2007

## Investor Compensation Fund

### Income and Expenditure Account

For the year ended 31 March 2007

(Expressed in Hong Kong dollars)

	Note	2007 \$'000	2006 \$'000
<b>Income</b>			
Net investment income	3&5	<b>108,932</b>	73,212
Exchange difference		<b>5,262</b>	(4,687)
Levy from the SEHK	3&6	–	144,983
Levy from the HKFE	3&6	–	11,464
		<b>114,194</b>	224,972
<b>Expenses</b>			
ICC expenses	7	<b>3,893</b>	3,263
Compensation expenses		<b>48,570</b>	–
Auditor's remuneration		<b>72</b>	65
Bank charges		<b>758</b>	1,125
Professional fees		<b>2,668</b>	2,469
Sundry expenses		<b>1</b>	1
		<b>55,962</b>	6,923
<b>Surplus</b>		<b>58,232</b>	218,049
<b>Accumulated surplus brought forward</b>		<b>571,528</b>	353,479
<b>Accumulated surplus carried forward</b>		<b>629,760</b>	571,528

The notes on pages 83 to 91 form part of these financial statements.

## Investor Compensation Fund

### Balance Sheet

At 31 March 2007

(Expressed in Hong Kong dollars)

	Note	2007 \$'000	2006 \$'000
<b>Current assets</b>			
Financial assets designated at fair value through profit or loss			
– Debt securities	9	1,548,070	1,357,440
– Equity securities	9	177,925	145,608
Interest receivable		24,516	17,848
Due from ICC		863	1,726
Fixed and call deposits with banks	10	27,800	152,341
Cash at bank	10	263	9
		<b>1,779,437</b>	1,674,972
<b>Current liabilities</b>			
Provision for compensation	8	45,214	–
Accounts payable and accrued charges		822	766
		<b>46,036</b>	766
<b>Net current assets</b>		<b>1,733,401</b>	1,674,206
<b>Net assets</b>		<b>1,733,401</b>	1,674,206
Representing:			
<u>Compensation fund</u>			
Contributions from UECF	11	994,718	994,718
Contributions from CECF	11	108,923	107,960
Accumulated surplus		629,760	571,528
		<b>1,733,401</b>	1,674,206

Approved and authorised for issue by the Securities and Futures Commission (the SFC) on 4 May 2007 and signed on its behalf by

**Eddy C Fong**  
Chairman of the SFC

**Martin Wheatley**  
Chief Executive Officer of the SFC

The notes on pages 83 to 91 form part of these financial statements.

## Investor Compensation Fund

### Statement of Changes in Equity

For the year ended 31 March 2007

(Expressed in Hong Kong dollars)

	<b>2007</b>	2006
	<b>\$'000</b>	\$'000
Compensation Fund balance as at 1 April	<b>1,674,206</b>	1,456,157
Surplus for the year	<b>58,232</b>	218,049
Contributions from CECF	<b>963</b>	–
Compensation Fund balance as at 31 March	<b>1,733,401</b>	1,674,206

The notes on pages 83 to 91 form part of these financial statements.

## Investor Compensation Fund

### Cash Flow Statement

For the year ended 31 March 2007

(Expressed in Hong Kong dollars)

	2007 \$'000	2006 \$'000
<b>Cash flows from operating activities</b>		
Surplus for the year	58,232	218,049
Net investment income	(108,932)	(73,212)
Exchange difference	(5,262)	4,687
Decrease in levies receivable	–	17,717
Decrease/(increase) in amount due from ICC	863	(615)
Increase in provision for compensation	45,214	–
Increase/(decrease) in accounts payable and accrued charges	56	(52)
Net cash (used in)/from operating activities	(9,829)	166,574
<b>Cash flows from investing activities</b>		
Purchase of debt securities	(1,827,241)	(3,331,795)
Sale or maturity of debt securities	1,650,868	3,146,281
Sale of equity securities	752	641
Interest received	60,200	51,691
Net cash used in investing activities	(115,421)	(133,182)
<b>Cash flows from financing activities</b>		
Contributions received from CECF	963	–
Net cash from financing activities	963	–
<b>Net (decrease)/increase in cash and cash equivalents</b>	(124,287)	33,392
<b>Cash and cash equivalents at beginning of the year</b>	152,350	118,958
<b>Cash and cash equivalents at end of the year</b>	28,063	152,350
<b>Analysis of the balance of cash and cash equivalents:</b>		
	2007 \$'000	2006 \$'000
Fixed and call deposits with banks	27,800	152,341
Cash at bank	263	9
	28,063	152,350

## Investor Compensation Fund

### Notes to the Financial Statements

For the year ended 31 March 2007

(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 compensation funds, the Unified Exchange Compensation Fund (UECF) and the Commodity Exchange Compensation Fund (CECF) (wound up on 26 May 2006). 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 (see also note 6).

#### 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** Levy income was recorded at a fixed rate on every leviabale 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.

## Investor Compensation Fund

### 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 and other financial liabilities.

We initially 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 the Fund 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 our 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.

## Investor Compensation Fund

### 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.

### 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>2007</b>	2006
	<b>\$'000</b>	\$'000
Interest income from bank deposits and debt securities	<b>66,744</b>	47,985
Realised gain/(loss) on disposal of equity securities	<b>3</b>	(1)
Realised gain on redemption/disposal of debt securities	<b>3,629</b>	5,578
Gain on revaluation of equity securities	<b>31,967</b>	24,467
Gain/(loss) on revaluation of debt securities	<b>6,589</b>	(4,817)
Net investment income	<b>108,932</b>	73,212

## Investor Compensation Fund

### 6. Levy from the SEHK/HKFE

From 1 April 2003, the Fund received a 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 was 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 2007, ICC incurred cost of \$3,893,000 for its operations (2006: \$3,263,000).

### 8. Provision for compensation

	\$'000
Balance as at 31 March 2006	–
Add: provision made during the year ended 31 March 2007	48,570
Less: compensation paid during the year ended 31 March 2007	(3,356)
Balance as at 31 March 2007	<u>45,214</u>

We made provision for liabilities arising from claims received resulting from two default cases (Tiffit Securities (Hong Kong) Limited and Wing Yip Company Limited) for which ICC has published a notice calling for claims pursuant to Section 3 of the Securities & Futures (Investor Compensation-Claims) Rules. The maximum liability of the Fund to claims for each default case is set at \$150,000 per claimant.

## Investor Compensation Fund

### 9. Financial assets designated at fair value through profit or loss

	2007 \$'000	2006 \$'000
(a) Debt securities		
(i) Listing status		
Listed - outside Hong Kong	365,445	385,850
Listed - in Hong Kong	106,428	–
Unlisted	1,076,197	971,590
	<b>1,548,070</b>	1,357,440
(ii) Maturity profile		
– Within one year	686,980	695,808
– After one year but within two years	491,983	442,602
– After two years but within five years	321,163	156,279
– After five years	47,944	62,751
	<b>1,548,070</b>	1,357,440
(iii) The weighted average effective interest rate of debt securities at 31 March 2007 was 4.66% (2006: 4.88%).		
(b) Equity securities		
Unlisted	177,925	145,608

### 10. Deposits with banks and cash at bank

The effective interest rate of deposits with banks and cash at bank at 31 March 2007 ranged from 3.91% to 5.3% (2006: 3.8% to 4.72%). The balances matured within one year at both 31 March 2007 and 31 March 2006.

### 11. 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. Up to 31 March 2007, the SFC paid \$994,718,000 (2006: \$994,718,000) and \$108,923,000 (2006: \$107,960,000) into the Fund from the UECF and the CECF respectively.

### 12. Related party transactions

We have related party relationships with the SFC, the ICC, the SEHK, the HKFE, the UECF and the CECF. The CECF was wound up in May 2006 and the remaining balance of \$962,535 was transferred to the Fund in accordance with Section 75(9) of the SFO. During the year, there were no significant related party transactions other than those disclosed in the financial statements (refer to notes 6, 7 & 11).

## Investor Compensation Fund

### 13. Financial instruments

The financial assets of the Fund comprise debt securities and units in a pooled fund. The underlying investments of the pooled fund mainly comprise 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, Hong Kong Government 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. The maximum exposure to credit risk is the carrying value of the assets in the balance sheet.

**(ii) Liquidity risk**

The Fund's policy is to regularly monitor current and expected liquidity requirement to ensure that it maintains sufficient reserves of cash to meet its liquidity requirements in the short and longer term.

**(iii) 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 debt 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.

**(iv) 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.

**(v) 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.

**(vi) Fair values**

All financial instruments are carried at amounts not materially different from their fair values as at 31 March 2007 and 2006.

### 14. Contingent liabilities

As at the date of this report, the Fund has eighty-one outstanding claims in respect of two intermediaries. The validity of these claims is under investigation. SFC or ICC has not yet published any notice calling for claims pursuant to Section 3 of the Securities & Futures (Investor Compensation-Claims) Rules in respect of these cases. We have not made any provision for these claims in view of the probability of outflow of economic benefit being remote. The maximum contingent liability of the Fund to these claims is \$7,784,000 (As at 31 March 2006: \$900,000).

## Investor Compensation Fund

### 15. Possible impact of amendments, new standards and interpretations issued but not yet effective for the annual accounting period ended 31 March 2007

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 2007 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
Amendments to IAS 1, Presentation of financial statements: capital disclosures	1 January 2007

The Fund is in the process of making an assessment of what the impact of these amendments, new standards and interpretations is expected to be in the period of initial application. So far it has concluded that the adoption of them is unlikely to have a significant impact on the Fund's results of operations and financial position.