

G.N. 2901

SECURITIES AND FUTURES ORDINANCE (Chapter 571)

Pursuant to section 240(9b) of the Securities and Futures Ordinance, the audited financial statements of the Investor Compensation Fund for the financial year ended 31 March 2005 are set out on pages 7420 to 7429:—

Peter AU-YANG *Chairman of
Investor Compensation Fund Committee*

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 2005.

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 7422 to 7429.

3. *MEMBERS OF THE COMMITTEE*

The members of the Committee during the year and up to the date of this report were:—

Mr. Peter AU-YANG	[appointed on 1 April 2005]
Mr. Mark DICKENS, J.P.	[resigned on 31 March 2005]
Mr. Paul CHOW Man Yiu, J.P.	[resigned on 20 September 2004]
Mr. Gerald GREINER	[appointed on 20 September 2004]
Mrs. Alexa LAM	
Ms. Anna H. Y. WU, S.B.S., J.P.	

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.

4 May 2005

On behalf of the Committee
Peter AU-YANG
Chairman

AUDITORS' REPORT
TO THE SECURITIES AND 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 7422 to 7429 which have been prepared in accordance with International Financial Reporting Standards promulgated by the International Accounting Standards Board.

Respective responsibilities of the SFC and auditors

The Securities and Futures Ordinance requires the SFC to keep proper accounts of the Fund and to prepare financial statements of the Fund in respect of each financial year. The directors of the SFC do so on the basis that these financial statements should give a true and fair view. In preparing financial statements which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently, that judgements and estimates are made which are prudent and reasonable and that the reasons for any significant departure from applicable accounting standards are stated.

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong 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 2005 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.

4 May 2005

KPMG
Certified Public Accountants
Hong Kong

INVESTOR COMPENSATION FUND
INCOME AND EXPENDITURE ACCOUNT
FOR THE YEAR ENDED 31 MARCH 2005

(Expressed in Hong Kong dollars)

	<i>Note</i>	<i>2005</i> \$'000	<i>2004</i> \$'000
<i>Income</i>			
Net investment income	3 & 5	28,668	4,643
Levy from the SEHK	3 & 6	163,914	144,177
Levy from the HKFE	3 & 7	13,279	10,340
		205,861	159,160
<i>Expenses</i>			
ICC expenses	8	4,066	4,434
Auditors' remuneration		55	50
Bank charges		947	55
Professional fees		1,539	12
Exchange difference		383	—
Sundry expenses		1	—
		6,991	4,551
<i>Surplus</i>		198,870	154,609
<i>Accumulated surplus brought forward</i>		154,609	—
<i>Accumulated surplus carried forward</i>		353,479	154,609

The notes on pages 7426 to 7429 form part of these financial statements.

INVESTOR COMPENSATION FUND
BALANCE SHEET
AT 31 MARCH 2005

(Expressed in Hong Kong dollars)

	<i>Note</i>	<i>2005</i> \$'000	<i>2004</i> \$'000
<i>Current assets</i>			
Debt securities	9	1,182,665	174,286
Equity securities		122,409	—
Other receivables		384	—
Interest receivable		13,731	1,656
Due from ICC		1,111	1,778
Levy receivable from the SEHK		16,434	16,415
Levy receivable from the HKFE		1,283	1,163
Fixed and call deposits with banks		81,663	766,964
Cash at bank		37,295	13
		1,456,975	962,275
<i>Current liabilities</i>			
Accounts payable and accrued charges		818	66
<i>Net current assets</i>		1,456,157	962,209
<i>Net assets</i>		1,456,157	962,209
Representing:—			
<i>Compensation fund</i>			
Contributions from UECF	10	994,718	699,640
Contributions from CECF	10	107,960	107,960
Accumulated surplus		353,479	154,609
		1,456,157	962,209

Approved and authorised for issue by the Securities and Futures Commission (the SFC) on 4 May 2005 and signed on its behalf by

Andrew L. T. SHENG
Chairman of the SFC

Eddy C. FONG
Non-executive Director of the SFC

The notes on pages 7426 to 7429 form part of these financial statements.

INVESTOR COMPENSATION FUND
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 MARCH 2005

(Expressed in Hong Kong dollars)

	<i>Note</i>	<i>2005</i> \$'000	<i>2004</i> \$'000
Compensation Fund balance as at 1 April		962,209	—
Surplus for the year		198,870	154,609
Contributions from UECF	10	295,078	699,640
Contributions from CECF	10	—	107,960
Compensation Fund balance as at 31 March		<u>1,456,157</u>	<u>962,209</u>

The notes on pages 7426 to 7429 form part of these financial statements.

INVESTOR COMPENSATION FUND
CASH FLOW STATEMENT
FOR THE YEAR ENDED 31 MARCH 2005

(Expressed in Hong Kong dollars)

	2005 \$'000	2004 \$'000
<i>Cash flows from operating activities</i>		
Surplus for the year	198,870	154,609
Net investment income	(28,668)	(4,643)
Exchange difference	383	—
Increase in levies receivable	(139)	(17,578)
Decrease / (Increase) in accounts receivable	667	(1,778)
Increase in accounts payable and accrued charges	752	66
	171,865	130,676
<i>Cash flows from investing activities</i>		
Purchase of debt securities	(2,729,479)	(218,378)
Purchase of equity securities	(99,990)	—
Sale or maturity of debt securities	1,692,647	43,000
Sale of equity securities	278	—
Interest received	21,582	4,079
	(1,114,962)	(171,299)
<i>Cash flows from financing activities</i>		
Contributions received from UECF	295,078	699,640
Contributions received from CECF	—	107,960
	295,078	807,600
Net (decrease) / increase in cash and cash equivalents	(648,019)	766,977
Cash and cash equivalents at beginning of the year	766,977	—
<i>Cash and cash equivalents at end of the year</i>	118,958	766,977
<i>Analysis of the balance of cash and cash equivalents:</i>		
	2005 \$'000	2004 \$'000
Fixed and call deposits with banks	81,663	766,964
Cash at bank	37,295	13
	118,958	766,977

INVESTOR COMPENSATION FUND
NOTES TO THE FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 MARCH 2005

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

2. ***MONEY CONSTITUTING THE FUND***

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

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

3. ***SIGNIFICANT ACCOUNTING POLICIES***

Basis of preparation

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

Recognition of income

Net investment income Net investment income comprises (i) interest income from bank deposits and debt securities; (ii) unrealised gain or loss on revaluation of debt securities and equity securities and (iii) realised gain or loss on redemption and disposal of debt securities and equity securities. We record interest income on an accrual basis.

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.

Investments

We classify our investments as current assets and state these investments at fair value with any resultant unrealised gain or loss recognised in the income and expenditure account. The fair value of the securities is their published closing prices or quoted bid prices at the balance sheet date. We account for purchases and sales of debt securities and equity securities on the settlement date. For those debt securities committed at the balance sheet date but not yet settled, we recognise their changes in value as income and other receivable in the income and expenditure account and balance sheet respectively.

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.

We calculate the recoverable amount of the Fund's investments in debt securities and 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. The recoverable amount of other assets is the greater of their net selling price and value in use. In assessing value in use, we discount the estimated future cash flows to their present value at a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, we determine the recoverable amount for the cash-generating unit to which the asset belongs.

We reverse an impairment loss in respect of an asset 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. 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.

Other receivables

We state other receivables at their cost less impairment losses.

Provision for compensation

We make provision for liabilities arising from claims resulting from defaults for which the SFC or ICC has published a notice calling for claims pursuant to section 3 of the Securities and Futures (Investor Compensation-Claims) Rules. The provision covers all such claims received up to the date on which the financial statements are approved by the SFC.

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

Other payables

We state other payables at cost.

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 or corporate entities.

4. *TAXATION*

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

5. *NET INVESTMENT INCOME*

	2005 \$'000	2004 \$'000
Interest income from bank deposits and debt securities	20,080	4,254
Realised gain on disposal of equity securities	44	—
Realised loss on redemption/disposal of debt securities	(2,252)	—
Gain on revaluation of equity securities	22,632	—
(Loss)/gain on revaluation of debt securities	(11,836)	389
Net investment income	<u>28,668</u>	<u>4,643</u>

6. *LEVY FROM THE SEHK*

From 1 April 2003, the Fund received a levy chargeable under Part 2 of the Securities and Futures (Investor Compensation—Levy) Rules at 0.002% of every leviable SEHK transaction.

7. *LEVY FROM THE HKFE*

From 1 April 2003, the Fund received a levy chargeable under Part 3 of the Securities and Futures (Investor Compensation—Levy) Rules at \$0.5 per leviable HKFE contract except for Mini-Hang Seng Index Futures Contracts, Mini-Hang Seng Index Options Contracts, Stock Futures Contracts and Options on Stock Futures Contracts, all of which are chargeable at \$0.1 per contract.

8. *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 2005, ICC incurred cost of \$4,066,000 for its operations (2004 : \$4,434,000).

9. *DEBT SECURITIES*

	2005 \$'000	2004 \$'000
Listed outside Hong Kong	654,186	90,028
Unlisted	528,479	84,258
	<u>1,182,665</u>	<u>174,286</u>

During the year, the Fund purchased from the UECF debt securities of total nominal value of HK\$61 million at market prices.

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 2005, the SFC paid \$994,718,000 and \$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 to 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) Exchange rate risk

The Fund's investment policy allows the Fund to have US dollar foreign exchange exposure. As the HK dollar is pegged with the US dollar, the Fund was not exposed to significant foreign exchange risk.

(iii) Market risk

The investment activities of the Fund expose it to various types of market risks which are associated with the markets in which it invests, to the extent of the amount invested in debt securities and equity securities. Such risk will be reflected in the price and the carrying value of the financial assets concerned.

13. *CONTINGENT LIABILITIES*

As at the date of this report, the Fund has received claims against 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 (2004: \$450,000).