
THIS DOCUMENT IS IMPORTANT AND REQUIRES YOUR IMMEDIATE ATTENTION

If you are in any doubt as to any aspect of this document, you should consult a stockbroker or other registered dealer in securities, a bank manager, solicitor, professional accountant or other professional adviser.

If you have sold all your shares in The Stock Exchange of Hong Kong Limited, you should at once hand this document and the accompanying forms to the purchaser or to the bank, stockbroker or other agent through whom the sale was effected for transmission to the purchaser.

Proposal for



香港聯合交易所

The Stock Exchange of Hong Kong Limited

(incorporated in Hong Kong with limited liability)

to become a wholly owned subsidiary of

Hong Kong Exchanges and Clearing Limited

(incorporated in Hong Kong with limited liability)

by way of a scheme of arrangement

(under section 166 of the Companies Ordinance)

and related proposals for



Hong Kong Futures Exchange Limited

and



HONGKONG CLEARING

香港結算

HONG KONG SECURITIES CLEARING COMPANY LIMITED

**to become wholly owned subsidiaries of
Hong Kong Exchanges and Clearing Limited**

Financial adviser to Hong Kong Exchanges and Clearing Limited



HSBC Investment Bank Asia Limited

Member HSBC Group

**Independent financial adviser to
The Stock Exchange of Hong Kong Limited**



Merrill Lynch

Merrill Lynch (Asia Pacific) Limited

SEHK
0414-9909
C.1

A letter from the Council containing its advice to the Stock Exchange Shareholders in relation to the Stock Exchange Proposal is set out on pages 7 to 13 of this document. A letter from the Independent Financial Adviser containing its advice to the Council in relation to the Stock Exchange Proposal is set out on pages 14 to 28 of this document. A letter from HKEC, containing information on the background to, and reasons for, the Overall Proposal, relevant aspects of the market reforms and the HKEC Group and its prospects, is set out on pages 29 to 54 of this document.

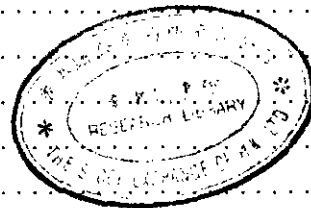
Notices of the Court Meeting and the Extraordinary General Meeting of the Stock Exchange to be held at 1st Floor, One & Two Exchange Square, Central, Hong Kong at 4:30 p.m. and 4:45 p.m., respectively on 27th September, 1999 are set out on pages 200 to 206 of this document. Whether or not you are able to attend the Meetings or either of them, you are requested to complete and sign the accompanying forms of proxy and return them to the registered office of the Stock Exchange, 1st Floor, One and Two Exchange Square, Central, Hong Kong, in accordance with the instructions printed thereon, as soon as possible and in any event by not later than the times stated in the paragraphs headed "Meetings and Action to be Taken by Stock Exchange Shareholders" on pages 62 to 65 of this document.

3rd September, 1999

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DEFINITIONS

In this document, the following expressions have the following meanings, unless the context requires otherwise:

“business day”	a day on which the Stock Exchange is open for the business of dealing in securities
“Cancellation Consideration”	the entitlement of each Stock Exchange Shareholder to HKEC Shares and/or cash in consideration of the cancellation under the Stock Exchange Scheme of each Stock Exchange Scheme Share held by such Stock Exchange Shareholder
“CCASS”	the Central Clearing and Settlement System operated by HKSCC
“Clearing Houses”	HKFECC, HKSCC and SEOCH
“Clearing Houses Ordinance”	the Securities and Futures (Clearing Houses) Ordinance, Chapter 420 of the Laws of Hong Kong
“Commodities Trading Ordinance”	the Commodities Trading Ordinance, Chapter 250 of the Laws of Hong Kong
“Companies Ordinance”	the Companies Ordinance, Chapter 32 of the Laws of Hong Kong
“Conditions”	the conditions to which the Stock Exchange Scheme is subject, which are set out on page 58 of this document
“Council”	the Council of the Stock Exchange
“Council Member(s)”	member(s) of the Council
“Court”	the High Court of Hong Kong
“Court Meeting”	the meeting of the Stock Exchange Shareholders for the purpose of approving the Stock Exchange Scheme, convened by direction of the Court, notice of which is set out on pages 200 and 201 of this document, and any adjournment thereof
“Effective Date”	the date on which the Stock Exchange Scheme becomes effective, being the date on which an office copy of the order of the Court sanctioning the Stock Exchange Scheme together with the minute containing the particulars as required by section 61 of the Companies Ordinance are registered by the Registrar of Companies

DEFINITIONS

“Election Deadline”	the date being a business day by which, as described on pages 64 and 65 of this document, an election for the Stock Exchange Cash Alternative must be lodged at the registered office of the Stock Exchange, which date shall be notified to the Stock Exchange Shareholders by the Stock Exchange in writing at least 14 days in advance and which shall be not less than 7 days before the Effective Date
“Enabling Legislation”	the legislation to enable certain steps to be taken to effect the Overall Proposal, further information on which is set out in the Letter from HKEC and appendix VI to this document
“Exchanges”	the Stock Exchange and the Futures Exchange
“Executive”	the Executive Director of the Corporate Finance Division of the SFC or any delegate of the Executive Director
“Explanatory Statement”	the explanatory statement set out on pages 55 to 65 of this document and issued in compliance with section 166A of the Companies Ordinance
“Extraordinary General Meeting”	the extraordinary general meeting of the Stock Exchange, notice of which is set out on pages 202 to 206 of this document, and any adjournment thereof
“Form of Election”	the form of election enclosed with this document (which may also be obtained from the Stock Exchange) for use by Stock Exchange Shareholders to make an election for the Stock Exchange Cash Alternative
“Futures Exchange”	Hong Kong Futures Exchange Limited, a public company incorporated with limited liability under the laws of Hong Kong
“Futures Exchange Cash Alternative”	the entitlement of a Futures Exchange Shareholder to receive some or all of the consideration under the Futures Exchange Scheme in cash
“Futures Exchange Cash Limit”	HK\$400.8 million, being the maximum amount of cash available under the Futures Exchange Cash Alternative
“Futures Exchange Group”	the Futures Exchange and its subsidiaries for the time being
“Futures Exchange Participant”	a person (natural or legal) who is authorised by the Futures Exchange under its rules to trade on or through its facilities

DEFINITIONS

“Futures Exchange Proposal”	the proposal that the Futures Exchange shall become a wholly owned subsidiary of HKEC by way of a scheme of arrangement under section 166 of the Companies Ordinance as described in the circular to Futures Exchange Shareholders, a copy of which is enclosed with this document for the information of Stock Exchange Shareholders
“Futures Exchange Scheme”	the scheme of arrangement between the Futures Exchange and the Futures Exchange Shareholders under section 166 of the Companies Ordinance as described in the circular to Futures Exchange Shareholders, a copy of which is enclosed with this document for the information of Stock Exchange Shareholders
“Futures Exchange Shareholder(s)”	registered holder(s) of Futures Exchange Shares
“Futures Exchange Shares”	ordinary shares of HK\$100,000 each in the share capital of the Futures Exchange and standard shares of HK\$25,000 each in the share capital of the Futures Exchange
“Futures Exchange Trading Right”	a conferred eligibility to trade on or through the Futures Exchange subject to the person being a Futures Exchange Participant
“Government”	the government of Hong Kong
“HK\$” and “Hong Kong dollar(s)”	Hong Kong dollar(s), being the lawful currency of Hong Kong
“HKEC”	Hong Kong Exchanges and Clearing Limited, a private company incorporated under the laws of Hong Kong with limited liability which will be the holding company of the Exchanges and HKSCC upon completion of the Overall Proposal
“HKEC Board”	the board of HKEC Directors
“HKEC Directors”	directors of HKEC
“HKEC Group”	HKEC and its subsidiaries for the time being
“HKEC Shares”	ordinary shares of HK\$1.00 each in the share capital of HKEC
“HKEC’s Financial Adviser”	HSBC Investment Bank Asia Limited
“HKFECC”	HKFE Clearing Corporation Limited, a private company incorporated with limited liability under the laws of Hong Kong and a wholly owned subsidiary of the Futures Exchange

DEFINITIONS

“HKSCC”	Hong Kong Securities Clearing Company Limited, a company incorporated with liability limited by guarantee under the laws of Hong Kong
“HKSCC Group”	HKSCC and its subsidiaries for the time being
“Hong Kong”	the Hong Kong Special Administrative Region of the People’s Republic of China
“Independent Financial Adviser” or “Merrill Lynch”	Merrill Lynch (Asia Pacific) Limited, the independent financial adviser to the Council
“Latest Practicable Date”	30th August, 1999, being the latest practicable date prior to the printing of this document for ascertaining certain information for inclusion in this document
“Letter from HKEC”	the letter from HKEC set out on pages 29 to 54 of this document
“Meeting(s)”	the Court Meeting and the Extraordinary General Meeting or either of them, as the case may be
“Newspapers”	one leading English language newspaper and one leading Chinese language newspaper published daily and circulating generally in Hong Kong
“Overall Proposal”	the Stock Exchange Proposal, the Futures Exchange Proposal and HKSCC becoming a company limited by shares and a wholly owned subsidiary of HKEC
“Policy Paper”	the paper entitled “A Policy Paper on Securities and Futures Market Reform” issued by the Government in March 1999
“Position Paper”	the paper entitled “Hong Kong Exchanges and Clearing Limited: Reinforcing Hong Kong’s Position as a Global Financial Centre” issued by the Government in July 1999
“SDI Ordinance”	the Securities (Disclosure of Interests) Ordinance, Chapter 396 of the Laws of Hong Kong
“Securities Ordinance”	the Securities Ordinance, Chapter 333 of the Laws of Hong Kong
“SEOCH”	The SEHK Options Clearing House Limited, a private company incorporated with limited liability under the laws of Hong Kong and a wholly owned subsidiary of the Stock Exchange
“SFC”	the Securities and Futures Commission

DEFINITIONS

“Stock Exchange”	The Stock Exchange of Hong Kong Limited, a public company incorporated with limited liability under the laws of Hong Kong
“Stock Exchange Cash Alternative”	the entitlement of a Stock Exchange Shareholder to receive some or all of the Cancellation Consideration in cash
“Stock Exchange Cash Limit”	HK\$935.2 million, being the maximum amount of cash available under the Stock Exchange Cash Alternative
“Stock Exchange Group”	the Stock Exchange and its subsidiaries for the time being
“Stock Exchange Participant”	a person (natural or legal) who is authorised by the Stock Exchange under its rules to trade on or through its facilities
“Stock Exchange Proposal”	the proposal that the Stock Exchange become a wholly owned subsidiary of HKEC by way of the Stock Exchange Scheme, as described in this document
“Stock Exchange Scheme”	the scheme of arrangement between the Stock Exchange and the Stock Exchange Shareholders under section 166 of the Companies Ordinance as set out on pages 192 to 199 of this document, with or subject to any modification thereof or addition thereto or condition(s) approved or imposed by the Court
“Stock Exchange Scheme Shares”	the Stock Exchange Shares in issue immediately prior to the Effective Date
“Stock Exchange Shares”	“A” shares of HK\$1.00 each in the share capital of the Stock Exchange
“Stock Exchange Shareholder(s)”	registered holder(s) of Stock Exchange Shares
“Stock Exchange Trading Right”	a conferred eligibility to trade on or through the Stock Exchange subject to the person being a Stock Exchange Participant
“Stock Exchanges Unification Ordinance”	the Stock Exchanges Unification Ordinance, Chapter 361 of the Laws of Hong Kong
“Takeovers Code”	the Hong Kong Code on Takeovers and Mergers
“Trading Right”	a Stock Exchange Trading Right and/or a Futures Exchange Trading Right, as applicable
“Transfer Approval Deadline”	the date which, as described on page 64 of this document, shall be notified as such to the Stock Exchange Shareholders by the Stock Exchange in writing at least 14 days in advance and which shall be not less than 14 days before the Effective Date

EXPECTED TIMETABLE

Latest time for lodging:

Pink forms of proxy for the Court Meeting (*note 1*) 4:30 p.m. on Saturday,
25th September, 1999

White forms of proxy for the Extraordinary
General Meeting (*note 1*) 4:45 p.m. on Saturday,
25th September, 1999

Court Meeting 4:30 p.m. on Monday, 27th September, 1999

Extraordinary General Meeting 4:45 p.m. (or as soon thereafter as the
Court Meeting shall have been
concluded or adjourned) on
Monday, 27th September, 1999

Court hearing of the petition to sanction
the Stock Exchange Scheme Monday, 11th October, 1999

Transfer Approval Deadline To be notified by the Stock Exchange in writing
and also announced in the Newspapers

Election Deadline (*note 2*) To be notified by the Stock Exchange in writing
and also announced in the Newspapers

Effective Date (*note 3*) To be notified by the Stock Exchange in writing
and also announced in the Newspapers

Notes:

1. *Forms of proxy should be lodged at the registered office of the Stock Exchange, 1st Floor, One and Two Exchange Square, Central, Hong Kong not later than the requisite time stated above. The pink form of proxy for the Court Meeting may alternatively be handed to the Chairman of that Meeting at the Meeting.*
2. *Forms of Election, completed in accordance with the instructions on them, must be lodged at the registered office of the Stock Exchange, 1st Floor, One and Two Exchange Square, Central, Hong Kong no later than 5:30 p.m. on the Election Deadline.*
3. *The Cancellation Consideration will be settled by the despatch of certificates representing HKEC Shares and/or cheques for the requisite cash amount within 10 days of the Effective Date.*

LETTER FROM THE COUNCIL



香港聯合交易所
The Stock Exchange of Hong Kong

Registered office:
1st Floor
One and Two Exchange Square
Central
Hong Kong

3rd September, 1999

**Proposal for the Stock Exchange to become
a wholly owned subsidiary of HKEC and
related proposals for the Futures Exchange and
HKSCC to become wholly owned subsidiaries of HKEC**

Dear Stock Exchange Shareholders,

INTRODUCTION

This document sets out detailed information regarding the proposal for the Stock Exchange to become a wholly owned subsidiary of HKEC. This is to be carried out through the cancellation of the Stock Exchange Shares held by the Stock Exchange Shareholders and, in consideration for the cancellation, the allotment and issue to the Stock Exchange Shareholders of HKEC Shares and/or, where an election is made, the payment of the Stock Exchange Cash Alternative, subject to the Stock Exchange Cash Limit.

Merrill Lynch is acting as the independent financial adviser to the Council.

The Council is writing to you to provide you with a summary of the Stock Exchange Proposal and to make a recommendation regarding approval of it.

None of the Council Members has a conflict of interest so as to require an independent committee of the Council to be established to consider the Stock Exchange Proposal from the point of view of Stock Exchange Shareholders and to make a recommendation on it.

BACKGROUND TO, AND REASONS FOR, THE STOCK EXCHANGE PROPOSAL

Your attention is drawn to the information set out under the heading "Background To, and Reasons For, the Overall Proposal" in the Letter from HKEC.

LETTER FROM THE COUNCIL

SUMMARY OF THE STOCK EXCHANGE PROPOSAL

Manner of implementation

It is proposed that the Stock Exchange Proposal will be implemented by way of the Stock Exchange Scheme, under section 166 of the Companies Ordinance, which will also involve a reduction of the share capital of the Stock Exchange and the provision of a loan of up to HK\$669.0 million from the Stock Exchange to HKEC.

Cancellation Consideration

Upon the Stock Exchange Scheme becoming effective it will be binding on the Stock Exchange and all Stock Exchange Shareholders. The Stock Exchange Scheme Shares will be cancelled and, in consideration for the cancellation, Stock Exchange Shareholders will be entitled to receive 747,845,000 HKEC Shares in aggregate. The Stock Exchange Scheme also offers Stock Exchange Shareholders the Stock Exchange Cash Alternative, which will be funded by bank borrowings of HKEC and internal resources of the Exchanges.

Accordingly, on the basis of the 929 Stock Exchange Shares in issue, each Stock Exchange Shareholder will be entitled to receive:

For each Stock Exchange Scheme Share held 805,000 HKEC Shares

Furthermore, under the Stock Exchange Cash Alternative, Stock Exchange Shareholders may elect on or before the Election Deadline to receive HK\$3.88 in cash for each HKEC Share in place of all or some of the HKEC Shares to which they become entitled under the Stock Exchange Scheme, subject to an overall aggregate limit of HK\$935.2 million (i.e. the Stock Exchange Cash Limit). On the basis of the 929 Stock Exchange Shares in issue, the Stock Exchange Cash Limit of HK\$935.2 million will enable 259,452 HKEC Shares to be replaced by cash (equivalent to HK\$1,006,673.76 in aggregate) for every Stock Exchange Scheme Share held. Accordingly, on this basis, under the Stock Exchange Scheme, a Stock Exchange Shareholder who elects for the Stock Exchange Cash Alternative up to a level of 259,452 HKEC Shares for each Stock Exchange Scheme Share held will have his election satisfied in full and will receive at least 545,548 HKEC Shares and up to HK\$1,006,673.76 in cash, depending on the size of the election, for each Stock Exchange Scheme Share in respect of which an election is made. In the event that a Stock Exchange Shareholder submits an election in respect of more than 259,452 HKEC Shares for each Stock Exchange Scheme Share held, the amount of cash in excess of the sum of HK\$1,006,673.76 to which he will be entitled will be dependent on the remaining balance of the Stock Exchange Cash Limit, if any. Any balance so available will be shared amongst such Stock Exchange Shareholders in place of HKEC Shares in the proportion that the size of the excess election made by each such Stock Exchange Shareholder in respect of each Stock Exchange Share bears to the total excess elections made by all Stock Exchange Shareholders, provided however that the amount paid to each Stock Exchange Shareholder shall be rounded down to the nearest whole multiple of HK\$3.88.

In the event that the aggregate amount of elections for the Stock Exchange Cash Alternative does not exceed the Stock Exchange Cash Limit, a Stock Exchange Shareholder

LETTER FROM THE COUNCIL

who elects to receive cash in respect of all of the HKEC Shares to which he becomes entitled under the Stock Exchange Scheme will receive, on the basis of the 929 Stock Exchange Shares in issue, HK\$3,123,400 in cash (equivalent to 805,000 HKEC Shares) for each Stock Exchange Scheme Share held, and no HKEC Shares.

The assured cash entitlement of each Stock Exchange Scheme Share is therefore HK\$1,006,673.76 on the basis set out above. If every Stock Exchange Shareholder makes an election to receive the Stock Exchange Cash Alternative equal to or in excess of the level of his assured cash entitlement, each Stock Exchange Shareholder will only receive the assured amount in cash and the rest of his entitlement will be in the form of HKEC Shares.

The entitlement of Stock Exchange Shareholders to HKEC Shares and/or to cash under the Stock Exchange Cash Alternative would need to be adjusted downwards if further Stock Exchange Shares were issued before the Effective Date. However, the Council has no authority to issue further Stock Exchange Shares without the approval of Stock Exchange Shareholders in general meeting, and does not intend to seek such approval.

Conditions and Timing

If approved by the Stock Exchange Shareholders and sanctioned by the Court, the Stock Exchange Scheme will become effective on satisfaction of all the Conditions set out on page 58 of the Explanatory Statement. The Conditions include enactment of the Enabling Legislation, which, it is stated in the Letter from HKEC, the Government anticipates will be enacted on or before 31st January, 2000. The latest date on which the Effective Date could occur is 31st March, 2000, or such later date as the Court may allow.

THE OVERALL PROPOSAL

Simultaneously with the Stock Exchange Scheme taking effect, the Futures Exchange Scheme will also take effect. Pursuant to the Enabling Legislation, HKSCC will become a company limited by shares and a wholly owned subsidiary of HKEC.

Upon completion of the Overall Proposal, the Stock Exchange, the Futures Exchange and HKSCC will all be wholly owned subsidiaries of HKEC.

COMPARISON WITH THE FUTURES EXCHANGE PROPOSAL

Upon the Futures Exchange Proposal becoming effective, Futures Exchange Shareholders will be entitled to receive 320,505,000 HKEC Shares in aggregate. Accordingly, on the basis of the 230 Futures Exchange Shares in issue, each Futures Exchange Shareholder will be entitled to receive 1,393,500 HKEC Shares in consideration for every Futures Exchange Share cancelled.

The Futures Exchange Proposal also offers Futures Exchange Shareholders the Futures Exchange Cash Alternative. Under the Futures Exchange Cash Alternative, Futures Exchange Shareholders may elect to receive HK\$3.88 in cash for each HKEC Share in place of all or some of the HKEC Shares to which they become entitled under the Futures Exchange Proposal, subject to an overall aggregate limit of HK\$400.8 million (i.e. the Futures Exchange Cash Limit).

LETTER FROM THE COUNCIL

In the event that the shareholders of one Exchange do not elect, pursuant to the cash alternative available to them, to receive cash up to the aggregate cash limit applicable to them, *the unused cash will not be applied towards the cash alternative available to the shareholders of the other Exchange.*

The Cancellation Consideration represents an exchange ratio as between Stock Exchange Shareholders and Futures Exchange Shareholders, respectively, of 70:30.

TRADING RIGHTS

From the Effective Date, ownership of shares in the Exchanges or HKEC and access to the trading facilities of the Exchanges will be separated. In the Letter from HKEC, HKEC confirms that one Stock Exchange Trading Right for each Stock Exchange Share held will automatically be conferred on all persons who are Stock Exchange Shareholders immediately prior to the Effective Date. All Stock Exchange Shareholders who are trading members of the Stock Exchange immediately prior to the Effective Date will automatically become Stock Exchange Participants. Accordingly, the position of Stock Exchange Shareholders, whether or not they are trading members of the Stock Exchange, will effectively be "grandfathered".

Save for Trading Rights issued in respect of alliances with other stock exchanges or futures exchanges, no Stock Exchange Trading Rights will be granted for two years from the Effective Date. Thereafter, save as aforesaid, in years three and four, no Stock Exchange Trading Right will be granted by HKEC for less than HK\$3.0 million. Stock Exchange Trading Rights automatically granted to Stock Exchange Shareholders upon completion of the Overall Proposal will be transferable within a period of 10 years from the Effective Date but such rights may only be transferred once. Your attention is drawn to the information set out in the paragraphs headed "Trading rights", "Opening up of trading rights", "Trading fees" and "Transferability" in the section of the Letter from HKEC headed "Relevant Material Aspects of the Market Reforms" on pages 35 to 39 of this document.

HKEC SHARES

As set out in the Letter from HKEC, the HKEC Shares will be freely transferable from the time they are issued.

It is proposed that no person (other than a person who falls within one of the categories of permitted persons) will be permitted to have an interest in more than 5 per cent. of the votes that could be cast on any resolution at any general meeting of HKEC. Your attention is drawn to the paragraph headed "Shareholding limit" in the section of the Letter from HKEC headed "Description of HKEC and the HKEC Group" on pages 39 to 46 of this document.

HKEC intends to obtain a listing for the HKEC Shares as soon as practicable and hopefully by 30th September, 2000.

PROSPECTS OF THE HKEC GROUP

Your attention is drawn to the section of the Letter from HKEC headed "Prospects of the HKEC Group" on pages 49 to 53 of this document.

LETTER FROM THE COUNCIL

MEETINGS

As you will see from the Notice of Court Meeting and Notice of Extraordinary General Meeting on pages 200 to 206 of this document, the Meetings have been convened for 4:30 p.m. and 4:45 p.m. on Monday, 27th September, 1999. The Meetings will be held at 1st Floor, One & Two Exchange Square, Central, Hong Kong. The Court has directed that the Court Meeting be held for the purpose of considering, and, if thought fit, approving (with or without modification) the Stock Exchange Scheme. Following the Court Meeting, the Extraordinary General Meeting will be held for the purpose of considering and, if thought fit, passing appropriate resolutions to approve and give effect to the Stock Exchange Scheme and all matters ancillary thereto and to approve certain changes to the objects clause in the Memorandum of Association of the Stock Exchange to give wider powers to the existing Council, and certain changes to the Articles of Association of the Stock Exchange to enable the existing Council to remain in office, pending the Stock Exchange Scheme taking effect. The amendments proposed to the Memorandum and Articles of Association of the Stock Exchange are subject to the approval of the SFC.

Whether or not you are able to attend the Meetings in person, you are strongly urged to complete and sign the enclosed pink form of proxy and white form of proxy in accordance with the instructions printed thereon respectively and to lodge them, at the registered office of the Stock Exchange, 1st Floor, One and Two Exchange Square, Central, Hong Kong, as soon as possible but in any case not later than the respective following times.

In order to be valid, the pink form of proxy for the Court Meeting should be lodged not later than 4:30 p.m. on 25th September, 1999 or may alternatively be handed to the Chairman of that Meeting at the Meeting.

In order to be valid, the white form of proxy for the Extraordinary General Meeting should be lodged not later than 4:45 p.m. on 25th September, 1999.

A proxy may only vote on a poll and not on a show of hands. A proxy must produce upon request at the Meeting his Hong Kong Identity Card or passport for identification purposes once a poll is taken. The completion and return of a form of proxy for the Court Meeting or the Extraordinary General Meeting will not preclude you from attending the relevant Meeting and voting in person. In that event, your form of proxy for the relevant Meeting will be deemed to have been revoked.

A body corporate which is a Stock Exchange Shareholder may by resolution of its directors or other governing body authorise such person as it thinks fit to act as its representative at any of the Meetings. A corporate representative is entitled to vote on a show of hands and on a poll.

Additional copies of the forms of proxy can be obtained from the registered office of the Stock Exchange, 1st Floor, One and Two Exchange Square, Central, Hong Kong during usual business hours on any business day up to 5:30 p.m. on 24th September, 1999.

LETTER FROM THE COUNCIL

Subject as set out immediately below, those persons who are registered as Stock Exchange Shareholders on the Stock Exchange's share register at the time the Meetings are held will be entitled to vote at the Meetings. At the Extraordinary General Meeting, in accordance with the Articles of Association of the Stock Exchange, the voting rights attaching to a Stock Exchange Share are not eligible to be exercised in any of the following circumstances:

1. if any moneys due from the Stock Exchange Shareholder are more than one month in arrears;
2. if the Stock Exchange Shareholder has died, become insane or of unsound mind, or has become bankrupt or, in the case of a corporation, has passed a resolution to wind up, or a court order for the appointment of a provisional liquidator or for winding up has been made against such corporation; or
3. if the Council or the Disciplinary Committee of the Council has resolved to suspend the membership of the Stock Exchange Shareholder.

Such restrictions will not apply to the eligibility of a Stock Exchange Shareholder to exercise voting rights at the Court Meeting. Voting rights at the Court Meeting may be exercised in person or by proxy or, in the case of a person claiming to exercise voting rights as the lawful representative of a Stock Exchange Shareholder, by such lawful representative acting in person or by proxy subject to production at the Court Meeting of evidence to the satisfaction of the Chairman thereof of the capacity in which and the authority by which the person claiming to act as the Stock Exchange Shareholder's lawful representative is entitled so to act.

FURTHER INFORMATION

You are urged to read carefully the letter from the Independent Financial Adviser set out on pages 14 to 28 of this document, the Letter from HKEC set out on pages 29 to 54 of this document, the Explanatory Statement set out on pages 55 to 65 of this document, the Stock Exchange Scheme set out on pages 192 to 199 of this document, the notices of the Meetings set out on pages 200 to 206 of this document and the appendices to this document.

You are also referred to the circular relating to the Futures Exchange Proposal, and to the proposed amended Memorandum of Association and the proposed new Articles of Association of the Stock Exchange (both of which will take effect upon the Effective Date subject to their being approved at the Extraordinary General Meeting), enclosed with this document.

CHANGES IN CIRCUMSTANCES

Stock Exchange Shareholders will vote on the Stock Exchange Proposal on the basis of the information contained in this document. Your attention is, however, drawn to the fact that much of the information contained in the Letter from HKEC, in appendix VI to this document entitled "Summary of the Enabling Legislation" and in appendix VII to this document entitled "Summary of relevant provisions in the Composite Bill" is in the form of proposals only (except, for the avoidance of doubt, the provisions relating to Trading Rights set out in paragraphs (a) to (d) under the heading "Relevant Material Aspects of the Market Reforms" in the Letter from

LETTER FROM THE COUNCIL

HKEC) which are subject to modification or amendment. Your attention is also drawn to the fact that upon satisfaction of the Conditions set out in paragraphs (a) to (d) under the heading "Conditions of the Stock Exchange Proposal" in the Explanatory Statement the Council will, at the time the board of the Futures Exchange does the same in respect of the Futures Exchange Scheme, deliver to the Registrar of Companies in Hong Kong for registration an office copy of the order of the Court in respect of the Stock Exchange Scheme, together with the minute containing the particulars required by section 61 of the Companies Ordinance, and that the Stock Exchange Scheme will become effective notwithstanding any event, series of events or circumstances concerning or relating to or otherwise having an adverse effect on, or any change in, local, national or international financial, political, economic, legal, fiscal, regulatory or market matters or conditions.

EFFECT OF THE OVERALL PROPOSAL NOT BEING IMPLEMENTED

The Government has stated, in the Policy Paper, that maintaining the status quo is not an option for Hong Kong, and that if the reforms proposed in that paper are not implemented by market participants, the Government will pursue alternative action that will achieve the primary objectives of those reforms.

The Government has subsequently reiterated that if the Overall Proposal fails to receive the required support from the shareholders of the Exchanges, the Government will be duty-bound to proceed with the reforms through alternative routes, including mobilising resources in existing statutes and pursuing new legislative and administrative measures. The Government's objectives include restructuring the governance of the Exchanges and Clearing Houses, reforming the market environment in terms of access for intermediaries, transaction levy and minimum commission structure and opening up the markets to greater competition.

RECOMMENDATION OF THE COUNCIL

Having considered the advice from Merrill Lynch which is set out on pages 14 to 28 of this document, the Council considers the terms of the Stock Exchange Proposal to be fair and reasonable from a financial point of view and recommends (i) that each Stock Exchange Shareholder vote in favour of the Stock Exchange Scheme at the Court Meeting and (ii) that each Stock Exchange Shareholder vote in favour of each of the resolutions set out on pages 202 to 204 of this document at the Extraordinary General Meeting.

Yours faithfully,
For and on behalf of the Council,
H.C. Lee
Chairman

Merrill Lynch (Asia Pacific) Limited

17/F, Asia Pacific Finance Tower
3 Garden Road, Central
Hong Kong



3rd September, 1999

The Council of
The Stock Exchange of Hong Kong Limited
1st Floor
One and Two Exchange Square
Central
Hong Kong

*To the Council of
The Stock Exchange of Hong Kong Limited*

Dear Council Members,

**Proposal for the Stock Exchange to become
a wholly owned subsidiary of HKEC and
related proposals for the Futures Exchange and
HKSCC to become wholly owned subsidiaries of HKEC**

1. INTRODUCTION

We understand that, pursuant to the Overall Proposal, each of the Exchanges proposes to enter into a scheme of arrangement under section 166 of the Companies Ordinance to become wholly owned subsidiaries of HKEC. Under the Stock Exchange Proposal, all Stock Exchange Scheme Shares will be cancelled under the Stock Exchange Scheme and, in consideration for the cancellation, Stock Exchange Shareholders will be allotted and issued HKEC Shares and/or, where an election is made, receive payment of the Stock Exchange Cash Alternative, subject to the Stock Exchange Cash Limit.

Simultaneously with completion of the Stock Exchange Proposal, the Futures Exchange Proposal will be completed. Under the Futures Exchange Proposal, the Futures Exchange Shareholders will also receive HKEC Shares in consideration for the cancellation of their Futures Exchange Scheme Shares and/or, where an election is made, payment of the Futures Exchange Cash Alternative, subject to the Futures Exchange Cash Limit. Pursuant to the Enabling Legislation, HKSCC will become a wholly owned subsidiary company of HKEC limited by shares. Upon completion of the Overall Proposal, the Stock Exchange, the Futures Exchange and HKSCC will all become wholly owned subsidiaries of HKEC.

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Further details of the Stock Exchange Proposal and the Overall Proposal are contained in the sections headed "Letter from the Council", "Letter from HKEC", and "Explanatory Statement" set out in the document dated 3rd September, 1999 (the "Scheme Document"), of which this letter forms a part. Terms used in this letter shall have the same meanings as defined in the Scheme Document unless otherwise defined herein.

You have asked Merrill Lynch for our advice as to whether the terms of the Stock Exchange Proposal are fair and reasonable from a financial point of view to the Stock Exchange Shareholders as a whole in their capacity as Stock Exchange Shareholders.

2. BASIS OF ADVICE

In giving its advice, Merrill Lynch is advising the Council in relation to the Stock Exchange Proposal only and is not advising any Council Members in their personal capacities other than as a Council Member, nor any Stock Exchange Shareholder, nor any other person, in relation to the Stock Exchange Proposal. Merrill Lynch will not be responsible to any person, other than the Council, for giving advice to any such person in relation to the Stock Exchange Proposal. In particular, Merrill Lynch will not owe any duties or responsibilities to any person, other than the Council, concerning the suitability of the Stock Exchange Proposal. It is understood that this letter and our opinion expressed herein is for the information and assistance of the Council only in connection with its consideration of the Stock Exchange Proposal except that this letter may be included in its entirety in the Scheme Document.

Our advice is necessarily based on market, economic, industry-specific and other conditions as they exist on, and the facts, information, forecast assumptions, estimates and opinions made available to us as of, the date of this letter. The Council should note, however, that at the Meetings, Stock Exchange Shareholders will be required to vote on the Stock Exchange Proposal on the basis of the information contained in the Scheme Document even though much of the information contained in the section headed "Letter from HKEC" in the Scheme Document and in appendix VI to the Scheme Document, entitled "Summary of the Enabling Legislation", is in the form of proposals only which are subject to modification or amendment.

In connection with the preparation of our opinion expressed herein, we have not solicited third-party indications of interest for the acquisition of all or any part of the Stock Exchange Shares nor have we considered alternative methods by which Stock Exchange Shareholders might realise the value of their Stock Exchange Shares.

In formulating our advice, we have relied upon, and have assumed to be true, accurate, complete and not misleading, the information, forecast assumptions, estimates and facts supplied, and opinions expressed, by the management, Council Members and directors, as appropriate, of the Stock Exchange, the Futures Exchange, HKSCC and HKEC, and on the information and representations referred to or made in the Scheme Document. We have assumed that the Council Members of the Stock Exchange, the directors of the Futures Exchange, the directors of HKSCC, and the directors of HKEC are satisfied that having made all reasonable enquiries, and to the best of their knowledge and belief, this is the case and that



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there is no material information relevant to the giving of our advice which has not been disclosed to us relating to their respective organisations. The Council Members of the Stock Exchange, the directors of the Futures Exchange, and the directors of HKEC have also collectively and individually accepted full responsibility, directly or indirectly, for the accuracy of the information contained in the Scheme Document relating to their respective organisations and confirmed, having made all reasonable enquiries, that to the best of their knowledge and belief there are no other facts, the omission of which would make any statement in the Scheme Document misleading. Nothing has come to our attention as at the date of this letter that would cause us to doubt the truthfulness or completeness of the facts and historical information that we have relied upon in arriving at our advice. However, we have not carried out any independent verification of the facts, information, forecast assumptions, estimates and opinions supplied to us nor have we received confirmation from the Council Members or directors, as appropriate, of the Stock Exchange, the Futures Exchange, HKSCC or HKEC as to either the truthfulness or the completeness of the facts, information, forecast assumptions, estimates and opinions provided to us nor have we conducted an independent investigation into the business and affairs, or an independent appraisal of the assets, of the Stock Exchange, the Futures Exchange, HKSCC or HKEC or the commercial viability and prospects of HKEC.

Furthermore, in arriving at our advice to the Council we have considered the terms of the Stock Exchange Proposal from a financial point of view to the Stock Exchange Shareholders as a whole in their capacity as Stock Exchange Shareholders. We have not considered the individual economic circumstances of, or any individual taxation consequences that might arise for, Stock Exchange Shareholders as a result of the implementation of the Stock Exchange Proposal or the Overall Proposal nor have we considered the overall effects of the implementation of the Government's reforms on Stock Exchange Shareholders in their capacity as Stock Exchange Participants.

3. ELIGIBILITY TO GIVE ADVICE

We confirm that Merrill Lynch is an independent financial adviser under Rules 2.6 and 2.7 of the Takeovers Code. Merrill Lynch does not have a connection, financial or otherwise, with the Stock Exchange, the Futures Exchange, HKSCC or HKEC that would be reasonably likely to: (i) create a conflict of interest; or (ii) affect the objectivity of our advice.

Prior to our engagement as the financial adviser to the Stock Exchange in connection with the Stock Exchange Proposal, Merrill Lynch had not previously been involved in giving any financial advice to the Exchanges and/or their respective managements, or been involved in any capital-raising, restructuring or similar transactions for the Stock Exchange, the Futures Exchange, HKSCC or HKEC. The only existing relationship between the Merrill Lynch Group and the Stock Exchange is that Merrill Lynch Far East Limited is a member of the Stock Exchange. In addition, Merrill Lynch Futures (Hong Kong) Limited is a member of the Futures Exchange. No representative of Merrill Lynch serves on the Council of the Stock Exchange or on the board of the Futures Exchange or is involved in the day-to-day management of either the Stock Exchange or the Futures Exchange.

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4. SCOPE OF WORK

In arriving at our advice to the Council set out below, we have, among other things:

- (i) reviewed the annual reports and related financial information for the five fiscal years in the period ended 30th June, 1998, the audited financial statements for the fiscal year ended 30th June, 1999, and the interim reports and related unaudited financial information for the semi-annual period ended 31st December, 1998 for the Stock Exchange and for HKSCC;
- (ii) reviewed the annual reports and related financial information for the five fiscal years in the period ended 31st December, 1998 for the Futures Exchange and the audited financial statements for the 12 month period ended 30th June, 1999;
- (iii) reviewed certain other information, including management accounts, financial budgets and forecast assumptions, relating to the business, earnings, cash flow, assets and prospects of the Stock Exchange, HKSCC, and the Futures Exchange furnished to us by the management of the Stock Exchange, HKSCC, and the Futures Exchange, respectively;
- (iv) conducted discussions with members of the senior management of the Stock Exchange, HKSCC, and the Futures Exchange concerning the business and prospects of their respective companies;
- (v) conducted discussions on valuation methodology and assumptions on financial forecasts with the independent financial adviser to the Futures Exchange, with HKEC's Financial Adviser, and with the Government's business structure adviser;
- (vi) undertaken relative valuation analysis of the Stock Exchange and the Futures Exchange on the basis outlined below in paragraph (f) of section 5 of this letter;
- (vii) reviewed the legal opinions obtained from UK Queen's Counsel by HKSCC in relation to the potential liability of HKSCC to pay UK Stamp Duty Reserve Tax ("UK SDRT") and relied upon these opinions;
- (viii) reviewed the information contained in the joint press announcement made by HKEC, the Stock Exchange and the Futures Exchange on 30th July, 1999 and in the Scheme Document;
- (ix) held discussions with representatives of HKEC's Financial Adviser and representatives of the Government's business structure adviser to confirm that alternative measures might be implemented by the Government to effect the stated objectives of the Overall Proposal in the event that the Stock Exchange Proposal is not effected; and
- (x) reviewed such other financial studies and analyses and performed such other investigations and taken into account such other factors as we deemed necessary.

5. PRINCIPAL FACTORS AND REASONS

In giving our advice to the Council, we have taken into consideration, among other things, the results of our work referred to above in section 4 of this letter and the following principal factors and reasons:

(a) Background to the Overall Proposal

On 3rd March, 1999, the Financial Secretary of Hong Kong announced a comprehensive reform of the securities and futures market, which included the merger of the Exchanges and the Clearing Houses under a new holding company, HKEC. Whilst we are not expressing any opinion on the Government's plans for reform or on the Overall Proposal, further information on the reform proposals, including the Government's reasons for and background to the reform proposals, are outlined in the Policy Paper and Position Paper (including the summary of the Position Paper) published on 3rd March, 1999 and 8th July, 1999, respectively.

In the Position Paper, the Government stated that "Globally and in Asia, the securities market and the exchange industry are changing dramatically. The exchange industry is becoming increasingly competitive and complex and as a result exchanges world-wide must adapt or risk disappearing."

The Policy Paper stated that "As technology advances, the threats to the traditional exchange structure will only increase. Business will migrate to those markets with high transparency and liquidity, low costs of intermediation, diversified product base, sound regulation, high quality of service and robust infrastructure.". In addition, the Position Paper also stated that "In the cash markets, a new breed of electronic communication networks (ECNs) has emerged. These ECNs...are siphoning significant trading volumes from traditional markets and intermediaries. Intermediaries are repositioning themselves to participate in alternative markets as their role and profits diminish in increasingly electronic markets."

Furthermore, the Position Paper stated that "maintaining the status quo is not an option for Hong Kong. Although the securities and futures market of Hong Kong has developed significantly over the last decade, our competitive advantages have been slowly and gradually eroded as the global market place evolves. In the face of intensifying competition, Hong Kong must take decisive steps to reform its market structure to maintain its competitiveness and reinforce its lead as a global financial centre.". The Policy Paper also stated that "The Government believes that the current fragmented nature of the ownership and governance structure of Hong Kong's Exchanges and Clearing Houses is not conducive to the timely and effective decision making which is required in the new competitive environment. Fundamental structural reform of the market operators is required to enable them to face these competitive challenges and make the necessary business-driven changes which will help to secure their future."

(b) Separation of Stock Exchange ownership and trading rights

Stock Exchange Shares currently represent ownership of the Stock Exchange and confer on such holders, subject to satisfying certain other qualifying criteria, the right to trade securities on the Stock Exchange. Implementation of the Stock Exchange Proposal will result in the separation of ownership of shares in the Stock Exchange or HKEC from Trading Rights as explained in more detail in the section headed "Explanatory Statement" in the Scheme Document.

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(c) Cancellation Consideration offered for Stock Exchange Scheme Shares

Upon the Stock Exchange Proposal becoming effective it will be binding on the Stock Exchange and on all Stock Exchange Shareholders. The Stock Exchange Scheme Shares will be cancelled and, in consideration for the cancellation, Stock Exchange Shareholders will be entitled to receive 747,845,000 HKEC Shares in aggregate. Accordingly, on the basis of the 929 Stock Exchange Shares in issue, Stock Exchange Shareholders will be entitled to receive Cancellation Consideration as follows:

For each Stock Exchange Scheme Share held 805,000 HKEC Shares

Under the Futures Exchange Proposal, the Futures Exchange Scheme Shares will be cancelled and, in consideration for the cancellation, Futures Exchange Shareholders will be entitled to receive 320,505,000 HKEC Shares in aggregate. Accordingly, on the basis of the 230 Futures Exchange Shares in issue, Futures Exchange Shareholders will be entitled to receive Cancellation Consideration as follows:

For each Futures Exchange Scheme Share held 1,393,500 HKEC Shares

The Cancellation Consideration represents an exchange ratio (the "Exchange Ratio") of 70 per cent. to 30 per cent. as between Stock Exchange Shareholders as a whole and Futures Exchange Shareholders as a whole, respectively, in terms of: (i) the total number of HKEC Shares that could be received by the respective shareholders in the Exchanges assuming that no shareholder in either Exchange elects to take the cash alternatives being offered under the respective proposals; and (ii) the total cash that could be received by the respective shareholders in the Exchanges assuming that all shareholders in the Exchanges elect to take the maximum level of cash available under the cash alternatives being offered under the respective proposals.

(d) Stock Exchange Cash Alternative

The Stock Exchange Scheme also offers Stock Exchange Shareholders the Stock Exchange Cash Alternative, which will be funded using bank borrowings of HKEC and internal resources of the Exchanges.

Under the Stock Exchange Cash Alternative, Stock Exchange Shareholders may elect to receive HK\$3.88 in cash for each HKEC Share in place of all or some of the HKEC Shares to which they become entitled under the Stock Exchange Scheme, subject to an overall aggregate limit, being the Stock Exchange Cash Limit, of HK\$935.2 million for all Stock Exchange Shareholders.

Accordingly, Stock Exchange Shareholders who elect for the Stock Exchange Cash Alternative up to a level of 259,452 HKEC Shares for each Stock Exchange Scheme Share held will have their elections satisfied in full and will receive at least 545,548 HKEC Shares and up to HK\$1,006,673.76 in cash, depending on the size of the election, for each Stock Exchange Scheme Share in respect of which an election is made. Stock Exchange Shareholders may however submit an election in respect of more than 259,452 HKEC Shares for each Stock Exchange Scheme Share held, in which event excess elections will, if necessary, be *pro-rated by reference to the balance of cash, if any,* remaining available out of the Stock Exchange Cash Limit as outlined in the section headed "Explanatory Statement" in the Scheme Document.

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In the event that the aggregate amount of elections for the Stock Exchange Cash Alternative does not exceed the Stock Exchange Cash Limit, Stock Exchange Shareholders who elect to receive cash in respect of all of the HKEC Shares to which they become entitled under the Stock Exchange Scheme will receive, on the basis of the 929 Stock Exchange Shares in issue, HK\$3,123,400.00 in cash for each Stock Exchange Scheme Share held, and no HKEC Shares.

In the event that Stock Exchange Shareholders do not elect to receive cash of up to the Stock Exchange Cash Limit or, as described in the section headed "Explanatory Statement" in the Scheme Document, in the event that Futures Exchange Shareholders do not elect to receive cash up to the Futures Exchange Cash Limit under the Futures Exchange Proposal, unutilised cash will not be applied towards the cash alternative available to the shareholders of the other Exchange. Accordingly, the Stock Exchange Cash Limit will not be increased.

As a result, the aggregate number of HKEC Shares owned by Stock Exchange Shareholders in proportion to the aggregate number of HKEC Shares owned by Futures Exchange Shareholders, upon the Overall Proposal becoming effective, will vary depending on the extent to which shareholders in the respective Exchanges elect to take the cash alternatives being offered under the respective proposals.

(e) Comparison of the Stock Exchange Cash Alternative to the pro forma net asset value and earnings of HKEC

On the basis of the pro forma combined net asset value of HKEC as at 30th June, 1999 (which is in turn based on the audited balance sheets of each of the Exchanges and of HKSCC as at 30th June, 1999) of HK\$4,153.1 million, and on the basis that the maximum number of HKEC Shares that could be received by the respective shareholders in the Exchanges (assuming that no shareholder in either Exchange elects to take the cash alternatives being offered under the respective proposals) is 1,068,350,002 HKEC Shares, the pro forma net asset value of HKEC as at 30th June, 1999 is equivalent to approximately HK\$3.89 per HKEC Share. The Stock Exchange Cash Alternative of HK\$3.88 per HKEC Share is therefore approximately equal to one times the pro forma net asset value of HKEC as at 30th June, 1999.

The table below sets out the current trading price to latest audited net asset value ratios of the Australian Stock Exchange Limited ("Australian Stock Exchange") and OM Gruppen AB ("OM Gruppen"):

	Price/ Net Asset Value Ratio ^(Note)
Australian Stock Exchange	6.40x
OM Gruppen	2.90x

Note: Based on trading prices and shares outstanding as reported at the Latest Practicable Date.
Source: Bloomberg

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On the basis of the pro forma combined earnings (surplus for the year) of HKEC for the year ended 30th June, 1999 (which is in turn based on the audited profit and loss statements of each of the Exchanges and of HKSCC for the 12 month period ended 30th June, 1999) of HK\$538.9 million, and on the basis that the maximum number of HKEC Shares that could be received by the respective shareholders in the Exchanges (assuming that no shareholder in either Exchange elects to take the cash alternatives being offered under the respective proposals) is 1,068,350,002 HKEC Shares, the pro forma earnings of HKEC for the 12 month period ended 30th June, 1999 are equivalent to approximately HK\$0.50 per HKEC Share. The Stock Exchange Cash Alternative of HK\$3.88 per HKEC Share is therefore approximately equal to 7.69 times the pro forma earnings of HKEC for the 12 month period ended 30th June, 1999.

The table below sets out the current trading price to latest audited earnings ratios of the Australian Stock Exchange and OM Gruppen:

	Price/ Earnings Ratio ^(Note)
Australian Stock Exchange	43.69x
OM Gruppen	20.87x

Note: Based on trading prices and shares outstanding as reported at the Latest Practicable Date.

Source: Bloomberg

The comparison made above in this paragraph (e) of this section 5 of this letter is relevant only to the Stock Exchange Cash Alternative of HK\$3.88 per HKEC Share offered under the Stock Exchange Proposal. The actual market value of HKEC Shares, either before listing or if and when they are listed, may be materially different from the value of the Stock Exchange Cash Alternative and the implied price to net asset value and price to earnings ratios of HKEC Shares may also be materially different from the current price to net asset value ratios and price to earnings ratios stated above for the Australian Stock Exchange and for OM Gruppen.

(f) **Relative Valuation Analysis of the Stock Exchange and the Futures Exchange**

Valuation methodology

For the purpose of reviewing the Exchange Ratio agreed between the Council and the board of the Futures Exchange only, and based on the scope of work outlined above in section 4 of this letter, we have prepared relative valuations of the Stock Exchange (including the full economic value of the clearing operations of the Stock Exchange currently undertaken by HKSCC) and the Futures Exchange based on discounted cash flow analysis. The discounted cash flow valuation methodology is based on the theory that the inherent or economic value of a business is equivalent to the sum of the projected free cash flows of the business discounted at a discount rate that reflects the risks associated with those cash flows. It is important to note that discounted cash flow analysis is an internationally accepted valuation methodology used commonly for companies whose shares are not listed.

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We have discussed the appropriateness of discounted cash flow analysis as a relative valuation methodology for the Exchanges, as opposed to the use of comparative trading multiple or transaction multiple valuation methodologies, with the independent financial adviser to the Futures Exchange, with HKEC's Financial Adviser, with the Government's business structure adviser, and with the management of the Stock Exchange. Our relative valuation analysis has been based on detailed, 10-year cash flow projections for each of the Stock Exchange (including the full economic value of the clearing operations of the Stock Exchange currently undertaken by HKSCC) and the Futures Exchange. By utilising a 10-year projection period, we have sought to address the potentially distorting effect of stock market cycles on the relative valuation of the Exchanges. Stock market cycles in Hong Kong may not coincide with the cycles of markets in which comparable companies trade or with market cycles in countries where comparable transactions have occurred. Furthermore, discounted cash flow analysis also addresses issues of: (i) differing accounting treatments; (ii) varying profit growth prospects; and (iii) abnormal and non-recurring earnings or costs that may not be addressed adequately through the use of comparable valuation methodologies based on public information only.

The use of discounted cash flow analysis as a valuation methodology is, however, highly sensitive to the assumptions adopted. For the purpose of reviewing the fairness of the agreed Exchange Ratio only, we have relied upon the forecast assumptions and other estimates furnished to us by the managements of the Stock Exchange and the Futures Exchange and have assumed that such forecast assumptions reflect the best currently available estimates and judgements of the managements of the Stock Exchange and the Futures Exchange, respectively, and that the resulting projections will be realised in the amounts and time periods contemplated thereby.

The net present value of the 10-year cash flows projections for each Exchange has then been calculated by applying a range of discount rates, assuming that both Exchanges have net cash positions. Finally, a range of perpetual growth rates has been applied to determine the terminal value of each Exchange at the end of the explicit 10-year cash flow projection period.

Attribution of value for clearing operations of HKSCC

The cash flow projections for the Stock Exchange used as the basis for agreement of the Exchange Ratio and as the basis for the preparation of our relative valuation analysis include full attribution of value for the alternative that the Stock Exchange theoretically has to establish its own, wholly owned business to undertake the clearing operations of the Stock Exchange that are currently undertaken by HKSCC. Our estimate of the relative value of the Stock Exchange on a discounted cash flow basis therefore in effect includes the full net present value of the future cash flows of HKSCC that would otherwise have been derived from the business of the Stock Exchange, taking into account the costs that may have to be incurred should the Stock Exchange start its own such clearing operations.

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This attribution of value to the Stock Exchange in the Exchange Ratio of the economic value of the clearing operations of the Stock Exchange currently undertaken by HKSCC must be considered in the context of the legal position of HKSCC as stated in the Policy Paper: "Currently, HKSCC is a company limited by guarantee which has no issued shares and, accordingly, no shareholders or owners.". At present, Stock Exchange Shareholders do not have any right to participate in the profits of HKSCC as a going concern nor do they have any right to participate in any distribution of the net assets of HKSCC on a winding up of the company. Following completion of the implementation of the Overall Proposal, Stock Exchange Shareholders who hold HKEC Shares will be entitled to share, proportional to their shareholding in HKEC, in any future profits of HKSCC and in the net assets of HKSCC by virtue of HKSCC becoming a wholly owned subsidiary company of HKEC limited by shares.

For reference only, the table below sets out the latest audited turnover and earnings of HKSCC for the year ended 30th June, 1999 and the audited net assets of HKSCC as at 30th June, 1999.

	HK\$'000
Turnover (Income) for year ended 30th June, 1999	441,241
Earnings (Surplus after taxation) for year ended 30th June, 1999	131,640
Net assets as at 30th June, 1999	1,235,560

It should be noted, however, that the profitability of HKSCC may fluctuate and that its value may rise or fall. Past performance is not necessarily a guide to future performance.

Other valuation methodologies

We have also compared the financial performance of the Stock Exchange and the Futures Exchange with those of certain other companies that could arguably be considered to be reasonably similar to either the Stock Exchange or the Futures Exchange. In addition, we have reviewed the terms of certain merger and acquisition transactions in the exchange industry, to the extent public data has been available, that could arguably be considered to be of a similar nature to a merger of the Exchanges. However, there are no directly comparable listed companies in Hong Kong nor have there been comparable merger or acquisition transactions in Hong Kong. Furthermore, we consider that the sample size of international, listed comparable companies or international, precedent mergers and acquisitions transactions is too small to be able to draw meaningful conclusions from data that is publicly available and, given the unique nature of both the Stock Exchange and the Futures Exchange in Hong Kong and the background against which the Exchange Ratio was agreed, we do not consider it appropriate to place reliance on these other, comparative valuation methodologies.

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Historical turnover and earnings of the Stock Exchange and the Futures Exchange

In considering the fairness of the agreed Exchange Ratio of 70 per cent. to 30 per cent. in favour of Stock Exchange Shareholders, we have also compared the historical turnover and earnings of each Exchange. A summary of this comparative analysis for the 12 month periods ended 30th June, 1998 and 30th June, 1999 is set out in the table below.

	HK\$'000			Relative Contribution	
	Stock Exchange	Futures Exchange	Total	Stock Exchange	Futures Exchange
Turnover					
12 months to 30th June, 1999	881,609	746,150	1,627,759	54%	46%
12 months to 30th June, 1998	1,153,533	815,980 ⁽¹⁾	1,969,513	59%	41%
Earnings					
12 months to 30th June, 1999	251,800	155,418	407,218	62%	38%
12 months to 30th June, 1998	388,938	296,028 ⁽²⁾	684,966	57%	43%

Notes:

- (1) Average of (i) turnover for the fiscal year ended 31st December, 1997 of HK\$714,429,000 and (ii) turnover for the fiscal year ended 31st December, 1998 of HK\$917,531,000.
- (2) Average of (i) operating surplus after taxation for the fiscal year ended 31st December, 1997 of HK\$284,891,000 and (ii) operating surplus after taxation for the fiscal year ended 31st December, 1998 of HK\$307,164,000.

Sources: For the Stock Exchange, audited financial statements for the fiscal years ended 30th June, 1999 and 30th June, 1998 and for the Futures Exchange, audited financial statements for the fiscal years ended 31st December, 1997 and 31st December, 1998 and the audited financial statements for 12 month period ended 30th June 1999.

Exchange Ratio

As stated above, the Cancellation Consideration represents an Exchange Ratio as between Stock Exchange Shareholders and Futures Exchange Shareholders of 70 per cent. to 30 per cent. in favour of Stock Exchange Shareholders. The Exchange Ratio was agreed and approved by the Council and the board of the Futures Exchange on 30th July, 1999. On the basis of the analysis described above in this paragraph (f) of this section 5 of this letter, we are of the opinion that the agreed Exchange Ratio is fair to the Stock Exchange Shareholders as between the Stock Exchange Shareholders as a whole and the Futures Exchange Shareholders as a whole. We must emphasise, however, that the valuation of non-publicly traded securities is inherently complex and subject to considerable uncertainty and fluctuation.

(g) Benefits of HKEC Share ownership

As outlined above in paragraph (c) of this section 5 of this letter, under the terms of the Stock Exchange Proposal, Stock Exchange Shareholders will be entitled to receive 805,000 HKEC Shares as *Cancellation Consideration for each Stock Exchange Scheme Share* currently held.

At present, members of the Exchanges have no right to receive dividends or other distributions except on liquidation and, accordingly, the profits of the Exchanges are not available to them. The Stock Exchange Proposal will, if implemented successfully in conjunction with the Overall Proposal, confer on Stock Exchange Shareholders the ability to share in any future profits of the Exchanges and realise the value of their shares upon any sale while retaining their trading rights. The Position Paper stated that "Members can for the first time enjoy the benefits of commercial ownership of the exchanges including potential dividends and capital appreciation following HKEC's listing.". The Position Paper also outlined HKEC's mission for competitiveness and stated that "HKEC will adopt a business structure which focuses on shareholder value creation and the search for long term business growth."

Furthermore, the Government has stated in the Policy Paper that listing of HKEC would, after the relevant legislative action being taken, "be targeted for as soon as practicable thereafter, with the intention that it be no later than 30 September, 2000." and that HKEC shareholders should "have a ready market for their shares."

Stock Exchange Shareholders therefore have the potential to enjoy the benefits of HKEC Share ownership identified by the Government and summarised above. However, *there can be no assurance that HKEC will be able to complete its plans for listing, or that if such a listing is completed, that an active trading market will develop, or, if it does develop, that it will be sustained following the completion of the listing.* The timing for listing and the ultimate valuation of HKEC Shares on listing are highly uncertain. The Council should note that we are not expressing any opinion as to the prices at which HKEC Shares may trade if and when they are issued or subsequently listed on the Stock Exchange. The Council should note also that, in arriving at our advice given herein, we have assumed that HKSCC or any subsidiary, associate, affiliate or successor thereof will not have to make any payment for UK SDRT or suffer any penalty in respect thereof on *the basis of the legal opinions obtained from UK Queen's Counsel by HKSCC and the statement made in the section headed "Letter from HKEC" in the Scheme Document.*

(h) Trading Rights

The Cancellation Consideration specifically does not include any measures with regards to Trading Rights. However, modification of Trading Rights does form part of the Overall Proposal. From the Effective Date, the holding of Trading Rights on the Stock Exchange will be entirely separate from the holding of shares in the Stock Exchange or HKEC. One Stock Exchange Trading Right for each Stock Exchange Scheme Share held will automatically be conferred on all persons who are Stock Exchange Shareholders immediately prior to the Effective Date.

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Although not part of the Cancellation Consideration, under the Overall Proposal, the HKEC Board has agreed that HKEC will:

- (i) *establish a moratorium on the issue of new Trading Rights (save for such rights as may be issued in respect of alliances with other stock exchanges or futures exchanges) for a period of two years from the Effective Date;*
- (ii) *for a further period of two years thereafter (i.e. in the third and fourth years), issue no new Trading Rights for less than HK\$3.0 million per Stock Exchange Trading Right or for less than HK\$1.5 million per Futures Exchange Trading Right; and*
- (iii) *allow Trading Rights which are granted to Stock Exchange Shareholders and to Futures Exchange Shareholders upon completion of the Overall Proposal to be transferable once within a period of ten years from the Effective Date to a person who is, or who simultaneously with completion of the transfer becomes, a Stock Exchange Participant or a Futures Exchange Participant, respectively. Details of the rules relating to the transferability of Trading Rights are contained in the section headed "Letter from HKEC" in the Scheme Document. Any new Trading Rights issued by HKEC (other than those automatically conferred on Stock Exchange Shareholders and Futures Exchange Shareholders on the Effective Date) will not be transferable.*

The value of a Trading Right can theoretically only be evaluated on an individual stockbroker basis, since different stockbrokers are likely to have different levels of revenues and costs associated with their respective businesses. Any valuation would necessarily be of a highly subjective nature, and will depend on the strategy and business of each individual stockbroker. Consequently, we are not able to express any opinion as to the fairness or reasonableness of the undertakings given by HKEC with respect to the *Stock Exchange Trading Rights or on the potential future value of Trading Rights on a stand alone basis for the Stock Exchange Shareholders as a whole.*

(i) **Expected benefits to Stock Exchange Shareholders of reform**

The *Policy Paper and Position Paper outlined the benefits that the Government envisages will result from implementation of the reforms. In addition to the anticipated benefits that Stock Exchange Shareholders will enjoy from ownership of HKEC Shares, considered above in paragraph (g) of this section 5 of this letter, the Position Paper also outlined a number of other benefits that might accrue to Stock Exchange Shareholders, including: (i) a broadened product range on the basis that "New product development will likely result from HKEC's pursuit of commercial objectives and the possibility of global alliances."; (ii) more efficient trading and clearing systems given that the "Merger will facilitate and stimulate the development of coherent systems across cash and derivative markets and the clearing operation, reducing unnecessary interfaces and enhancing efficiency."; and (iii) higher cost efficiency in technology investment as costs "will be shared among different business units, resulting in higher cost efficiency and stronger technology comparative advantage."*

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In addition, in outlining the benefits of the reform process for the market, members and the public, the Government stated in its Policy Paper that it "is satisfied that these benefits could not be fully exploited by pursuing a selective integration of only certain functions of the market operators falling short of a full merger."

Stock Exchange Shareholders therefore have the potential to enjoy the benefits summarised above that the Government expects to result from implementation of the reforms.

(j) Effects of the Stock Exchange Proposal not being implemented

On 22nd July, 1999, the Government issued two press releases stating, among other things, that the Government's objectives for the reform process include "reforming the market environment in terms of market access for intermediaries, levy and commission structure, restructuring the governance of the exchanges and clearing houses, rationalising the market regulatory functions and opening up the markets for more competition.". The Government stated in the Policy Paper that "If market participants are unable or unwilling to effect such reforms in the expeditious manner dictated by the pace of change in the global market, then in the larger interests of Hong Kong, the Government will pursue alternative action that will achieve the primary objectives of these reforms."

Alternatives available to the Government stated respectively in the press releases and in the Policy Paper might include "a comprehensive plan mobilising [the Government's] resources in existing statutes, pursuing new legislation and through administrative means." or may include, among other things, a "review and necessary reform of the current market environment and governance structure of the Exchanges and Clearing Houses in order to induce competition, promote investor interests and, above all, ensure that the interests of the Exchanges and the securities and futures market as a whole are sufficiently safeguarded and suitably balanced as against those of the members."

6. ADVICE

To summarise, in arriving at our advice we have taken into consideration, among other things, the results of our work referred to above in section 4 of this letter and the following principal factors and reasons, each of which is explained above in more detail in section 5 of this letter:

- The background to the Overall Proposal, of which the Stock Exchange Proposal forms a part, including the likely impact on Stock Exchange Shareholders of general industry trends and global competitive forces as set out in the Policy Paper and the Position Paper.
- The fact that implementation of the Stock Exchange Proposal will enable Stock Exchange Shareholders to separate trading rights from ownership of the Stock Exchange. The Council should note however that the timing for listing of HKEC Shares and the future valuation and liquidity of trading rights and of HKEC Shares are both highly uncertain.

LETTER FROM THE INDEPENDENT FINANCIAL ADVISER

- The fairness to Stock Exchange Shareholders of the Exchange Ratio of 70 per cent. to 30 per cent. in favour of Stock Exchange Shareholders agreed between the Council and the board of the Futures Exchange on the basis of our relative valuation analysis utilising the forecast assumptions and estimates supplied to us by each Exchange and, in particular, on the basis that full economic value has been attributed in the Exchange Ratio to Stock Exchange Shareholders for the clearing operations of the Stock Exchange presently undertaken by HKSCC, an entity that currently has no legal owners.
- The potential benefits of owning HKEC Shares identified by the Government, including the right to participate in any future profits of HKEC and the opportunity to hold a marketable security following HKEC's planned listing.
- The undertakings given by HKEC with respect to trading rights which have been offered by HKEC in addition to the Cancellation Consideration.
- The other benefits to Stock Exchange Shareholders that the Government envisages will result from implementation of the Overall Proposal which include a broadened product range, more efficient trading and clearing systems, and higher cost efficiency in technology investment.
- The potential financial consequences for Stock Exchange Shareholders of the Overall Proposal not being implemented and the Government pursuing "alternative action that will achieve the primary objectives of the reforms."

Based upon and subject to the foregoing and such other matters as we consider relevant, we advise the Council of the Stock Exchange, as at the date hereof, to advise the Stock Exchange Shareholders that the terms of the Stock Exchange Proposal considered as a whole are fair and reasonable from a financial point of view to the Stock Exchange Shareholders as a whole in their capacity as Stock Exchange Shareholders.

We express no opinion, however, as to the fairness or reasonableness of the Stock Exchange Cash Alternative separately, on the basis outlined above in paragraph (e) of section 5 of this letter. Stock Exchange Shareholders who consider that HKEC will achieve a valuation on listing in net present value terms of greater than HK\$3.88 per HKEC Share, who do not need to realise cash proceeds from their investment in the near term, and who are willing to accept the risks and limitations associated with holding unlisted securities until such listing, should not elect for the Stock Exchange Cash Alternative for all or part of their entitlement. On the other hand, Stock Exchange Shareholders who consider that HKEC will achieve a valuation on listing in net present value terms of less than HK\$3.88 per HKEC Share, or who need to realise cash proceeds from their investment in the near term, or who are not willing to accept the risks and limitations associated with holding unlisted securities, should elect for the Stock Exchange Cash Alternative for all or part of their entitlement.

Yours faithfully,
For and on behalf of
Merrill Lynch (Asia Pacific) Limited
Gary Stead
Managing Director, Mergers and Acquisitions

LETTER FROM HKEC

HONG KONG EXCHANGES AND CLEARING LIMITED

(incorporated in Hong Kong with limited liability)

Directors:

LEE Yeh Kwong, Charles (*Chairman*)
Rafael HUI
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3rd September, 1999

**Proposal for the Stock Exchange to become
a wholly owned subsidiary of HKEC and
related proposals for the Futures Exchange and
HKSCC to become wholly owned subsidiaries of HKEC**

Dear Stock Exchange Shareholders

INTRODUCTION

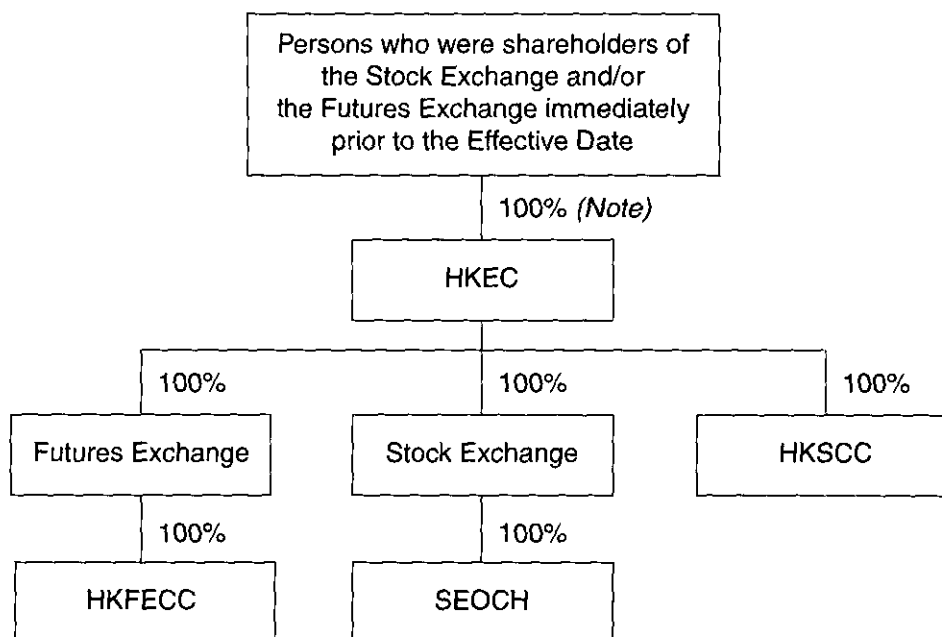
In his Budget Speech of 3rd March, 1999, the Financial Secretary of Hong Kong announced a comprehensive reform of the securities and futures markets in Hong Kong to enhance Hong Kong's competitiveness in an increasingly globalised financial marketplace. The reform includes fundamental changes in the market structure to be achieved through the *demutualisation and merger of the five recognised and approved market operators in Hong Kong*, namely the Stock Exchange, the Futures Exchange, HKSCC, SEOCH and HKFECC, under a single holding company, HKEC. The Overall Proposal forms part of this reform and, if implemented, will result in the Stock Exchange, the Futures Exchange and HKSCC all becoming wholly owned subsidiaries of HKEC.

It is the intention of Government and the HKEC Board that HKEC should become a listed corporation which will pursue profit-driven commercial goals on the one hand and effectively perform its public functions on the other. This letter sets out more details on, among other things, the market reform proposals, the proposed Enabling Legislation, the proposed business and regulatory framework for HKEC and the future prospects of HKEC.

LETTER FROM HKEC

THE OVERALL PROPOSAL

It is proposed that the Stock Exchange should become a wholly owned subsidiary of HKEC. At the same time the Futures Exchange and HKSCC will also become wholly owned subsidiaries of HKEC. The corporate structure of the HKEC Group, immediately following implementation of the Overall Proposal, will be as follows (ignoring nominee interests):



Note: A maximum of two HKEC Shares may be retained by The Financial Secretary Incorporated

HKEC Shares will be freely transferable, even prior to their listing. It is also proposed by HKEC to explore the feasibility of establishing a mechanism for matching, during the period following the Effective Date and prior to HKEC Shares being listed, potential purchasers of HKEC Shares with potential sellers.

As detailed below in the paragraphs headed "Shareholding limit" in the section of this Letter from HKEC headed "Description of HKEC and the HKEC Group", it is proposed that no person (other than a person who falls within one of the categories of permitted persons) will be permitted to have an interest in more than 5 per cent. of the votes that could be cast on any resolution at any general meeting of HKEC.

Accordingly, immediately following completion of the Overall Proposal, it is expected that HKEC will have no substantial shareholders, i.e. a person who holds 10 per cent. or more of the voting rights of HKEC.

BACKGROUND TO, AND REASONS FOR, THE OVERALL PROPOSAL

Set out below in this section headed "Background To, and Reasons For, the Overall Proposal", save where otherwise indicated, is a summary of relevant parts of the Policy Paper and the Position Paper. Save where expressly stated as being those of the HKEC Directors, all views, intentions and opinions expressed are those of the Government.

(a) Introduction

The global securities and futures industry is evolving rapidly with exchanges facing increasing competition from each other and from independent trading systems which bypass traditional exchanges. As technology advances, the threats to the traditional exchange structure will only increase. Business can be expected to migrate to those markets with high transparency and liquidity, low costs of intermediation, diversified product base, sound regulation, high quality of service and robust infrastructure.

Against this background, exchanges worldwide are rethinking their strategies and operations to improve their services, reinforce their competitive positions and optimise their performance. Overseas, markets are rapidly integrating vertically (e.g. linking together trading, clearing and settlement functions into a single transaction chain) and horizontally (e.g. combining securities and futures products into a single organisation) and developing alliances with other exchanges. Consolidation is the order of the day.

(b) The challenges faced by the Hong Kong market

(i) Competition from other traditional exchanges

Hong Kong is facing increasing competition from other Asian markets. Supported by their governments, the region's securities and futures markets (particularly Singapore, Kuala Lumpur and Taipei) are investing heavily to take advantage of domestic growth opportunities, and are keen to capture regional business. Further, as financial markets become more globalised and investors become more sophisticated, competition from further afield has also become an increasing challenge. Stocks of major listed companies on the Stock Exchange can be traded easily in London and, increasingly, also in New York. Financial and equity based derivatives are even less geographically bound and growing international competition in this area will be a fact of life in the future.

(ii) Securities and futures industry changing dramatically

In addition to increasing competition from other traditional exchanges, the industry in Hong Kong faces challenges caused by the dramatic changes that are occurring in the securities and futures industry.

First, advances in computer technology have led to significant changes in the landscape of the securities market, both exchange-based and "over-the-counter". Technological advances have lowered the entry barriers to establishing new exchanges, and this has led to the widespread emergence in recent years of alternative and proprietary trading systems which are executing trades outside traditional exchanges. In the cash markets, the new breed of electronic communication networks ("ECNs") that has emerged - including Instinet, Tradebook, Archipelago and Island - are already siphoning

significant trading volumes from traditional markets and intermediaries. Intermediaries are repositioning themselves to participate in the alternative markets as their role and profits diminish in increasingly electronic markets. In Asia, although these trends have not materialised as dramatically as in the United States or Europe, early signals are apparent, with Instinet and Bloomberg LP already having announced plans to expand their presence in the region. In the global futures and derivatives industry the pace of change is no less dramatic. Throughout the 1990s, intermediaries and investors have been empowered by far greater information dissemination. Coupled with deregulation of financial markets and capital flows, derivatives traders are able to redirect their order flows quickly to markets which provide the most efficient pricing and liquidity. This has led to a consolidation of liquidity and trading centres, particularly for financial derivatives, which are easily de-linked from the underlying local cash markets. The net effect is that local futures exchanges are losing their grip on domestic products and investors as futures trading transcends national borders. Though less of an immediate threat in derivatives, electronic trading services could also pose significant challenges to the traditional players.

Secondly, institutional investors and large, proprietary trading operations of investment banks and securities firms have become extremely powerful, demanding and more global. They are diversifying their trading through various markets and trading facilities, or trading directly among themselves, as they search for the best combination of transaction cost, liquidity and price discovery. This is creating competition among existing exchanges and encouraging growth of the alternative and proprietary systems. It is also resulting in demands for investors to have direct access to stock exchanges and representation in their governance.

Thirdly, progressively more governments and securities authorities are opening up their national markets to international participation, recognising that this makes the markets more competitive and efficient, brings in a larger and more diverse investor base and enables knowledge and skills transfer to the local market. Alternative trading systems are also being effectively recognised in the new regulatory frameworks that are being established.

(iii) *Hong Kong's market structure is becoming outdated*

As the demands of the market have changed, Hong Kong's current model is progressively less suited to coping with the complex and competitive global environment. The Exchanges presently perform four different roles (market operator, membership association, regulator and public body) that in practice conflict with one another, compromise their conduct and impair their overall performance. The growth of the market has been impeded by restrictions on access, including the maximum number of seats available. Shortcomings in the co-operation between the Exchanges have led to overlaps, as well as gaps, between the products and services offered by them and the diversion of resources and focus from external to internal competition. Additionally, Hong Kong's securities market infrastructure remains functionally fragmented, with a securities transaction involving multiple steps and necessitating multiple system and counterparty interfaces. This is inefficient and increases the risks involved. However, providing an integrated clearing system and straight-through processing requires a substantial investment in resources and systematic co-ordinated action in its implementation.

(iv) *Exchanges world-wide forced to adapt or disappear*

Exchanges around the world are being forced to adopt new performance-driven organisations to launch upon a path of transformation.

Strategies to compete and survive are represented by a host of demutualisations, public offerings, mergers of cash and derivative markets, and clearing operations, and newly forged cross-border alliances. New initiatives, some even more fundamental in nature, are also being adopted. Many exchanges are revamping their organisations and culture to become more commercial and competitive. Many are segmenting their client bases and market models, and are setting up marketing teams to promote their products and services. They are investing heavily to upgrade information technology ("IT") systems and to reduce transaction costs, moving to fully electronic platforms, streamlining and accelerating processing, and providing market access to new customer groups. In short, exchanges are becoming increasingly client- and profit-driven business organisations in order to sharpen their appeal to users.

In Asia, some markets have already adopted new structures and strategies and, in several cases, have reacted faster than Hong Kong. The Australian Stock Exchange demutualised and listed in 1998. The HKEC Directors additionally draw to the attention of Stock Exchange Shareholders that, subsequent to the issue of the Position Paper, Singapore has announced that the merger and demutualisation of the Stock Exchange of Singapore and SIMEX will be completed on 1st December, 1999 and that, globally, both the London and New York stock exchanges have announced plans to demutualise.

(c) **The way forward for Hong Kong**

Hong Kong's securities and futures market will have not only to strengthen its existing success drivers, but also develop new competitive strengths. Through the Stock Exchange Proposal and the Futures Exchange Proposal, and the transition to their operation under HKEC as a professionally-managed, profit-making corporation free from the constraints of mutual ownership and co-operative management, with a listing on the Stock Exchange, the Government believes that the right environment will be created for each of the Stock Exchange and the Futures Exchange to enhance its performance. More specifically:

- in today's global environment where investors have the facility to move freely between securities and futures markets, open access to trading facilities by non-member brokers and possibly in the longer term by investors themselves is likely to be a determining factor in the success of an international exchange;
- as an exchange serves the interests of not only its broker members, but also other capital market participants, such as issuers, investors and other financial services providers, a normal corporate structure will enable ownership and management to reflect broader user interests and to respond to market forces;
- demutualisation will result in professional management and organisational streamlining. The move away from management by committees dominated by vested interests will enable more effective and timely decision-making by reference to best prevailing corporate practices;

LETTER FROM HKEC

- a publicly listed company is able to raise capital more flexibly than a mutual association since it can use capital markets. This is essential given the increasing financial burdens facing exchanges arising from the need to provide users with state-of-the-art trading and settlement systems. The critical role played by such sophisticated and costly information technology in the modern market place cannot be understated since the consequences of system failure may impact upon the wider economy beyond the securities and futures markets; and
- public listing will promote truly public ownership and encourage the market operators to subject themselves to transparency, accountability and market discipline.

Without reform the Hong Kong securities and futures industry will not be able to maintain its competitiveness and face global challenges. This will also adversely impact on the broader interests of the economy and Hong Kong's status as a regional and an international financial centre.

Maintaining the status quo is not an option for Hong Kong and, if reforms are not implemented in accordance with the timetable set out by Government then, in the larger interests of Hong Kong, the Government will pursue alternative action that will achieve the primary objectives of these reforms. This may include, among other things, review and necessary reform of the current market environment and governance structure of the Exchanges and the Clearing Houses. Meanwhile, the Government will continue to pursue its established policy objectives to improve and strengthen the clearing infrastructure in Hong Kong through the integration of the current sector-based clearing and settlement systems to improve risk management, enhance market stability and integrity, and generally better protect investor and public interests.

In addition to the above, the HKEC Directors draw to the attention of Stock Exchange Shareholders various other statements made by the Government reiterating its position on, and commitment to, reform of the Hong Kong securities and futures industry. These include:

- if the Stock Exchange Proposal and the Futures Exchange Proposal fail to receive the required support from shareholders in the Exchanges, the Government will be duty-bound to proceed with reform through other means;
- alternative routes for achieving the reforms would include mobilising resources in existing statutes, pursuing new legislation and administrative measures;
- the Government wants the market to be more open, more competitive and access for newcomers to be possible, and that it wants all impediments and protectionist measures in the existing market structure to be removed; and
- the Government's objectives include reforming the market environment in terms of market access for intermediaries, transaction levy and minimum commission structure, restructuring the governance of the Exchanges and Clearing Houses, rationalising the market regulatory functions and opening up the markets to greater competition.

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RELEVANT MATERIAL ASPECTS OF THE MARKET REFORMS

(a) Trading rights

From the Effective Date, ownership of shares in the Exchanges or HKEC and access to the trading facilities of the Exchanges will be separated.

By law, any person carrying on a business of dealing in securities, or carrying on a business of trading commodity futures contracts in Hong Kong, has to be licensed by the SFC or fall within one of the licensing exemptions. In addition to this, and consistent with the Position Paper, any person who wishes to carry on such a business through the facilities of an Exchange will need to hold a Trading Right for that Exchange. The Trading Right will confer on its holder the eligibility to trade on the relevant Exchange (such eligibility is presently derived from the holding of shares in the Exchanges).

However, the holding of a Stock Exchange Trading Right will not, of itself, permit the holder to actually trade on or through the Stock Exchange. In order to do this it will additionally be necessary for the person to be a Stock Exchange Participant in accordance with the rules of the Stock Exchange, including those requiring compliance with all relevant legal and regulatory requirements.

One Stock Exchange Trading Right for each Stock Exchange Scheme Share held will automatically be conferred on all persons who are Stock Exchange Shareholders immediately prior to the Effective Date. Authorisations to trade on or through the facilities of the Stock Exchange will be unaffected by the new arrangements and Stock Exchange Shareholders who are trading members immediately prior to the Effective Date will automatically become Stock Exchange Participants. Accordingly, the position of Stock Exchange Shareholders, whether or not they are trading members of the Stock Exchange, will effectively be “grandfathered”.

Following completion of the Overall Proposal, the Stock Exchange will continue to regulate, in accordance with its rules, which products may actually be traded by each Stock Exchange Participant.

(b) Opening up of trading rights

Although not part of the Cancellation Consideration or the consideration under the Futures Exchange Proposal, the HKEC Board has determined that HKEC will establish a moratorium on the issue of new Trading Rights (save for such rights as may be issued in respect of alliances with other stock exchanges or futures exchanges) for a period of two years from the Effective Date. For a further period of two years thereafter (i.e. in the third and fourth years) no new Trading Rights will be issued for less than HK\$3.0 million per Stock Exchange Trading Right or for less than HK\$1.5 million per Futures Exchange Trading Right. Trading Rights issued by HKEC (other than those automatically conferred on Stock Exchange Shareholders and Futures Exchange Shareholders on the Effective Date) will not be transferable.

(c) Trading fees

Consistent with the Position Paper, the fees payable in respect of Trading Rights will be for HKEC to determine, subject to safeguards appropriate to a monopoly situation as described

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below in the paragraphs headed "Checks and balances for public interests". It is likely that the fees will include a one-off admission fee where a Trading Right is acquired from the relevant Exchange, and an annual fee, but no decision on this, and consequently the amounts of such fees, has yet been taken by the HKEC Board. As indicated above, in years three and four the admission fee for a Stock Exchange Trading Right will be not less than HK\$3.0 million.

No admission fee will be payable in consequence of the automatic grant of a Stock Exchange Trading Right upon completion of the Overall Proposal. Additionally, no admission fee will be payable by the transferee of a Stock Exchange Trading Right where the right is transferred on its "once-only" occasion as referred to in (d) below.

(d) Transferability

Ownership of a Stock Exchange Trading Right will be recorded in an appropriate manner by the Stock Exchange. Holders will be issued with an appropriate instrument which shall be prima facie evidence of title to the Stock Exchange Trading Right.

In order to permit Stock Exchange Shareholders to realise their investment in having access to the trading facilities of the Stock Exchange, and in order to allow those who wish to enter the marketplace to gain access, Stock Exchange Trading Rights which are automatically granted to Stock Exchange Shareholders upon completion of the Overall Proposal will be transferable. However, any such transfer must take place within a period of 10 years from the Effective Date and such rights may only be transferred once.

The following will be deemed not to be transfers:

- (a) the transmission of a Stock Exchange Trading Right to a person in consequence of the death of its recorded holder;
- (b) the assignment of a Stock Exchange Trading Right from an individual to a company of which he is the sole beneficial owner; and
- (c) a liquidator, receiver or trustee in bankruptcy taking possession of a Stock Exchange Trading Right in such capacity. However, any subsequent sale by the liquidator, receiver or trustee in bankruptcy will be treated as a transfer.

A transfer of a Stock Exchange Trading Right will be deemed to occur if there is a change in control of a company (or of any holding company of such company) which holds a Stock Exchange Trading Right where the company which holds the Stock Exchange Trading Right is not, at the time of the change in control, a Stock Exchange Participant. For this purpose, "control" means the holding of or the right to exercise more than half of the voting power of a company. For the avoidance of doubt, any direct or indirect (as described above) change in control of a company which is a Stock Exchange Participant at the time of the change in control will not be deemed to be a transfer of the Stock Exchange Trading Right held by that company.

A Stock Exchange Trading Right will only be permitted to be transferred to a person who is, or who simultaneously with completion of the transfer becomes, a Stock Exchange Participant.

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A Stock Exchange Trading Right cannot be fragmented into separate rights for different products unless so authorised by the rules of the Stock Exchange.

(e) Remote access

It is provided in the Position Paper that it will be for HKEC to determine the precise response to developments in the area of remote access (i.e. the ability to trade on or through the facilities of the Exchanges from locations outside Hong Kong). The Government has suggested in the Position Paper that HKEC should retain flexibility in order to facilitate strategic alliances with overseas exchanges, subject to such alliances being considered commercially prudent by HKEC and being acceptable to the SFC.

(f) Transaction costs

The HKEC Board supports the Government's long stated objective to reduce transaction costs in order to enhance the competitiveness of the Hong Kong market. The HKEC Board will explore with the Government how best to pursue this policy objective under the new market environment. To date, no specific proposals to alter any existing practice have been formulated.

(g) Checks and balances for public interests

It is provided in the Position Paper that, while HKEC will be a profit-driven commercial entity, it will also be a key strategic economic asset of Hong Kong. It is also provided in the Position Paper that it will be necessary for there to be appropriate checks and balances in place in light of:

- (i) the monopoly position over the stock market of HKEC and the Stock Exchange which will become its wholly owned subsidiary after the implementation of the Stock Exchange Scheme; and
- (ii) the role of HKEC in safeguarding the integrity and stability of the financial system of Hong Kong.

The Position Paper further provides that the framework of checks and balances, which will be built on the current statutory regulation of the Exchanges and HKSCC, will comprise:

- the corporate governance structure described below in the paragraphs headed "Corporate governance" in the section of this Letter from HKEC headed "Description of HKEC and the HKEC Group";
- as currently applicable in relation to the Exchanges, a requirement that the making of any changes to the rules of the Exchanges or HKSCC, which among other things set out their fees and charges, must be approved by the SFC. The SFC will develop non-statutory guidelines as to the factors to be taken into account in considering the level of fees and charges, which will include the comparative transaction costs of Hong Kong and other markets;

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- entrusting the risk management function to a committee of HKEC, as described below in the paragraphs headed "Corporate governance" in the section of this Letter from HKEC headed "Description of HKEC and the HKEC Group". On matters of *fundamental importance to the risk management function*, the decisions of this committee will require the consent of the SFC;
- a shareholding limit, the proposed form of which is described below under the heading "Shareholding limit" in the section of this Letter from HKEC headed "Description of HKEC and the HKEC Group"; and
- regulation of HKEC as a listed company by the SFC to avoid a conflict of interest and to *ensure a level playing field between HKEC and other listed companies which will be subject to the listing rules administered by HKEC*.

(h) Rationalised market regulation

It is stated in the Position Paper that, on the basis of recommendations from the SFC and following discussions between the Government and senior market figures, the Government has endorsed the following model in respect of the future division of regulatory functions between the SFC and HKEC:

- *market surveillance* — the division of functions will remain substantially as at present, albeit with clearer delineation and refinement of respective responsibilities which will be formalised in written procedures. HKEC's market surveillance will focus on trading operations and risk management whilst the SFC will be primarily responsible for detecting market malpractices with statutory implications;
- *intermediaries supervision* — the prudential regulation function currently performed by the Exchanges, including routine inspections of the businesses of members of the Exchanges, monitoring their compliance with conduct rules and the liquid capital requirements, and ensuring that members of the Exchanges have in place proper systems of management and control, will be moved to the SFC. HKEC would still need to retain a capacity though to ensure that its risk management measures are adequate and that trading rules are properly complied with. The SFC accepts that resourcing implications of this proposal have to be carefully examined and addressed;
- *compensation arrangements for investors* — the current statutory compensation schemes under the Securities Ordinance and the Commodities Trading Ordinance will be maintained, with modifications so that they cover the users of all HKEC trading facilities. In the longer term, the Government intends to revamp the arrangements, as envisaged in the consultation paper issued by the SFC in September 1998 entitled "A Consultation Paper on New Investor Compensation Arrangements for Hong Kong"; and
- *listing/corporate finance* — the division of responsibilities between the Stock Exchange and/or HKEC and the SFC will remain substantially as at present, albeit with improvements in efficiency within the Stock Exchange and in the co-ordination of functions undertaken by both the SFC and the Stock Exchange. This will necessarily involve a re-examination of the allocation of resources within the Stock

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Exchange Listing Division and an examination of the functions and work processes in the Listing Division. The SFC contemplates entering into a new Memorandum of Understanding clarifying the standards to be met by the Stock Exchange (and HKEC) in performing its functions in these areas and providing for greater interaction between the two bodies.

THE ENABLING LEGISLATION AND THE COMPOSITE BILL

The HKEC Directors draw to the attention of Stock Exchange Shareholders the summary set out in appendix VI to this document of the main features of the Enabling Legislation. Additionally, the HKEC Directors draw to the attention of Stock Exchange Shareholders the summary set out in appendix VII to this document of the relevant provisions of the current draft of the legislation for consolidating and modernising the existing legislation governing the securities and futures markets and clearing houses. Both of these summaries were provided to the HKEC Directors by the Government. The HKEC Directors have been advised by the Government that the Government anticipates that the Enabling Legislation will be enacted on or before 31st January, 2000.

DESCRIPTION OF HKEC AND THE HKEC GROUP

Set out below in this section headed "Description of HKEC and the HKEC Group", save where otherwise indicated, is an overview of the business and governance structure for HKEC proposed in the Position Paper. It is stated in the Position Paper that the business structure proposed is believed by the Government to have all the essential elements to enable HKEC to achieve its aspirations. However, it is also stated in the Position Paper that adjustments to the structure are possible when the model is developed in further detail and put into practice, and that adjustments may be required as the global and domestic markets evolve. Accordingly, save where expressly stated as being those of the HKEC Directors, all views, intentions and opinions expressed in this section are those of the Government.

The HKEC Directors draw to the attention of Stock Exchange Shareholders that they are at an early stage in considering the detailed implementation of the proposed structures and that no decisions have been made in this respect. However, the HKEC Directors are currently not aware of any material variations that they would wish to make from the structures proposed in the Position Paper.

(a) Introduction

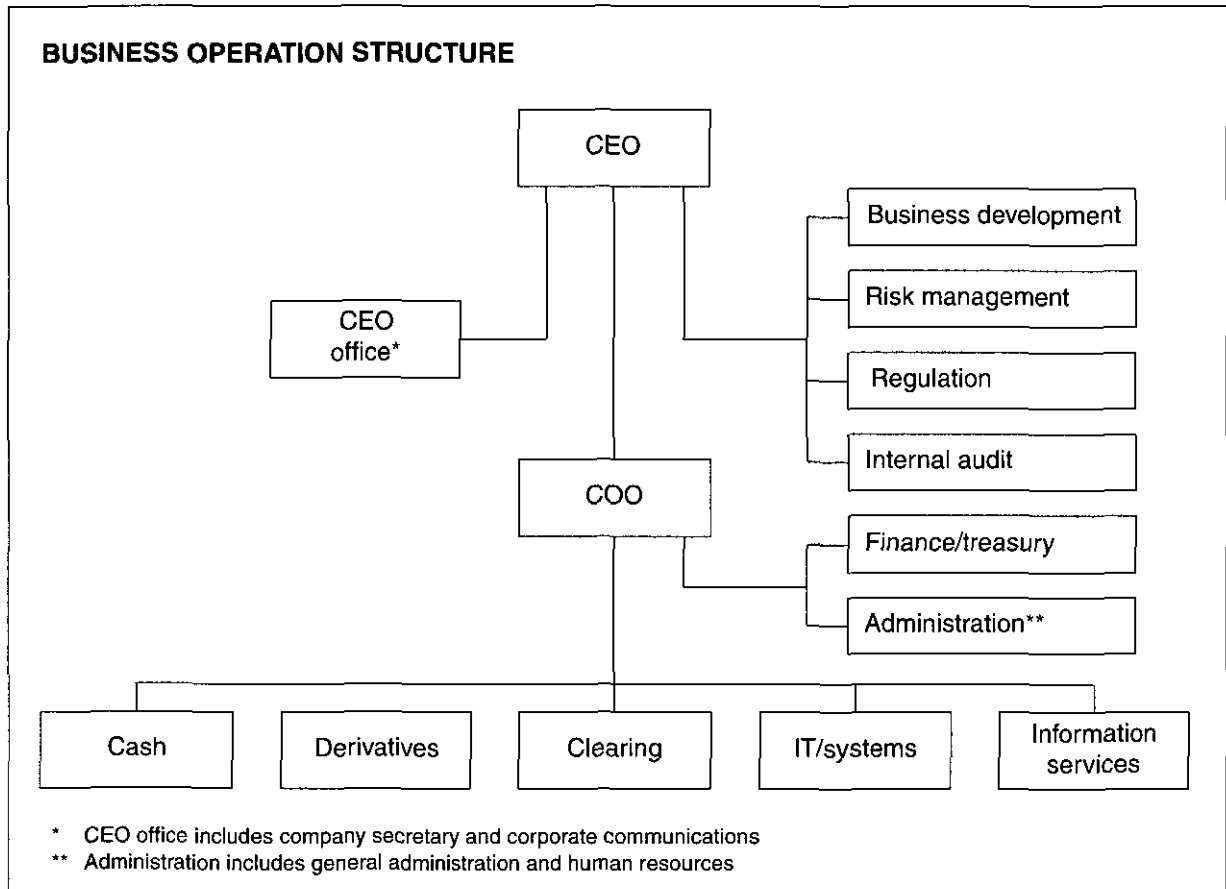
It is provided in the Position Paper that the HKEC Board will shape policies on major strategic, financial, regulatory, risk management, commercial and operational issues. It will be small in size to facilitate discussions and decision-making, minimise the need for sub-committees and leave the operational and commercial execution role to the management. The medium-term objective is to increase the representation of shareholder interests over time as ownership of HKEC diversifies. In the transitional phase, however, given the magnitude of the market reform, the public interests at stake and the initial undiversified shareholding structure of HKEC, it is important for HKEC's key stakeholders to be represented on the HKEC Board in a balanced fashion.

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HKEC will create a business organisation structured around three dimensions: strong *integrated and balanced leadership*; *focused and commercially driven business units* (“BUs”) directly supervised and controlled by HKEC’s management and the HKEC Board; and effective centralised staff and administrative functions.

(b) Business structure

The overall business structure of HKEC, as envisaged in the Position Paper, is summarised below:



HKEC’s leadership structure will include three individuals - the Chairman, the Chief Executive Officer (“CEO”) and the Chief Operating Officer (“COO”), and two leadership committees - the Executive Committee and the Management Committee:

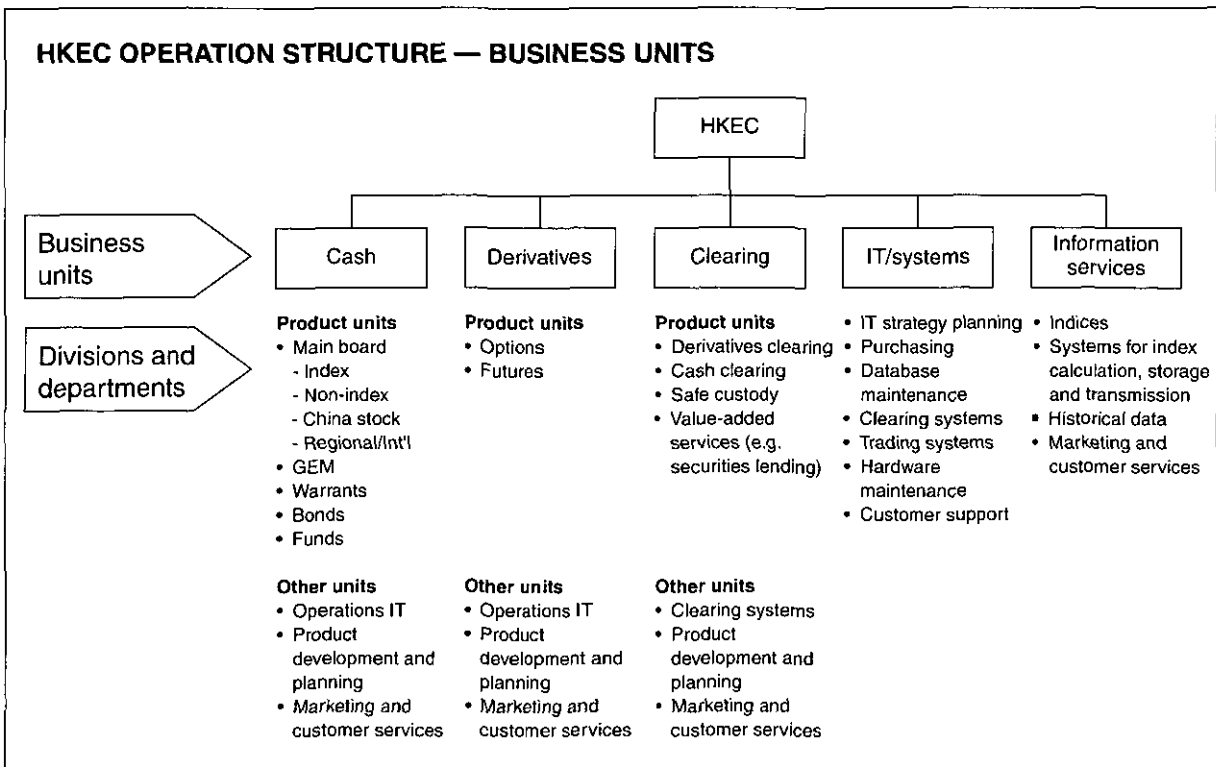
- *Non-executive Chairman* - who will focus on chairing the HKEC Board, supervising the CEO and COO and optimising relationships with external constituencies at the policy level;
- *Chief Executive Officer* - who will focus on devising strategy and securing regional and global alliances, and supervising and optimising HKEC’s market operations. He will also have direct oversight of risk management and regulatory functions; and
- *Chief Operating Officer* - who will focus on building HKEC as an integrated commercial and profit-making entity.

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HKEC's daily management responsibilities will be carried out by the *Executive Committee* and the *Management Committee* whose tasks, composition and operating mode are summarised in the table below:

OPERATIONAL LEADERSHIP			
	Key task	Composition	Operating mode
Executive Committee:	<ul style="list-style-type: none"> • Review key issues related to HKEC strategy and operation • Prepare submissions to the HKEC Board • Make operational decisions on listing and regulatory issues • Decide on key staff recruitment, evaluation and compensation 	<ul style="list-style-type: none"> • Chairman • CEO • COO • 2 HKEC Directors 	<ul style="list-style-type: none"> • Weekly meeting
Management Committee:	<ul style="list-style-type: none"> • Co-ordination among business units and functions • Resolving cross-BU issues • Initiate synergy capture and operational improvements • Building common operating mode and culture 	<ul style="list-style-type: none"> • CEO • COO • BU heads • Central function heads 	<ul style="list-style-type: none"> • Weekly meeting

HKEC's activities will be grouped into five distinct BUs. The proposed responsibilities of each BU are summarised in the table below:



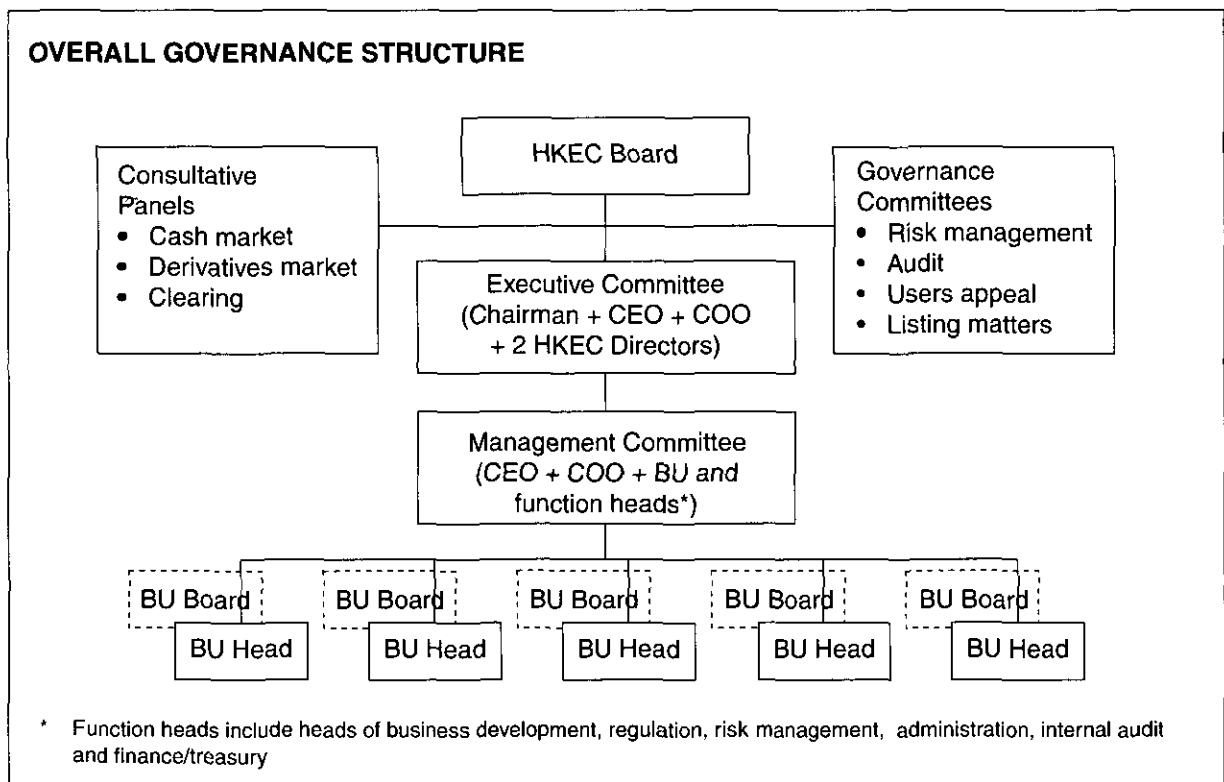
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The following functions will also be grouped together as departments or units:

- *business development* - a department reporting to the CEO, composed of cross-product marketing teams covering institutional investors, retail investors and intermediaries, which will also have responsibilities for HKEC's business strategy;
- *regulation* - a unit reporting to the CEO and which will be structured into four functions: listing (including issuer compliance, equivalent to the current listing division of the Stock Exchange), admissions (including user compliance), surveillance and enforcement;
- *risk management* - a unit reporting to the CEO and established to build excellence in market and user associated risks;
- *administration* - a unit reporting to the COO and responsible for human resources, communications and general support functions;
- *internal audit* - a unit reporting to the CEO and responsible for, among other things, *budget control and the auditing function*; and
- *finance and treasury* - a unit reporting to the COO and responsible for, among other things, asset and liability management, operational funding and cash management.

(c) Corporate governance

The overall governance structure of HKEC, as envisaged in the Position Paper, is summarised below:



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The HKEC Board must balance two main interests, namely its shareholders' interests, and the market and public interests. The design in the evolution of the HKEC Board structure as detailed below also takes into account the consideration that as the ownership of HKEC diversifies over time, the representation of the shareholders' interests on the HKEC Board can also be expected to increase. Such evolution also reflects the four distinct phases in the early years of HKEC that require corresponding adjustments in the composition of the HKEC Board.

The following sets out a summarised version of the Government's preferred composition of the HKEC Board at four different stages:

	Preparatory HKEC Board		Inaugural HKEC Board	Second HKEC Board
	July 1999	October 1999	on or after Effective Date	2003
Groups				
Shareholders in HKEC	0	0	6	6
Public/market* representatives	4	7	8	5-8**
CEO	0	0	1	1
Total HKEC Board members	4	7	15	12-15
* Market representatives include traders, issuers, fund managers and other groups of intermediaries and market-related professionals				
** Depending on commercial and operational needs of HKEC as well as the diversification of shareholding, subject to review in 2001/2002				

The preparatory HKEC Board has been appointed by the Government and represents in essence the public and market interests.

The preparatory HKEC Board will be enlarged in October 1999, assuming the Stock Exchange Proposal and the Futures Exchange Proposal are approved, and will comprise three additional HKEC Directors appointed by Government to represent the Stock Exchange, the Futures Exchange and HKSCC, respectively. Such representatives are not being appointed beforehand in order to avoid potential conflicts of interest.

The inaugural HKEC Board will include six additional HKEC Directors returned by HKEC's shareholders. The number of Government appointees representing public and market interests will be increased to eight. The CEO will be an ex-officio member, giving a total board of fifteen.

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Second HKEC Board. It is believed by the Government that, as HKEC matures, the size of the HKEC Board could be reduced. In addition, as the ownership of HKEC becomes more diversified over time, it is appropriate to increase the representation of shareholder interests on the HKEC Board, while still maintaining a reasonable representation of public and market interests through HKEC Directors appointed by the Government. Consequently, when the term of the inaugural HKEC Board expires, the size of the HKEC Board could be reduced from fifteen to, say, twelve. The number of HKEC Directors to be returned by shareholders would remain at six and the number of HKEC Directors to be appointed by the Government could be reduced. The CEO would remain an ex-officio member of the HKEC Board. However, depending on the actual commercial and operational needs of HKEC at the time and the pace of diversification of shareholding in HKEC, there may be grounds to maintain the HKEC Board on a similar scale to the inaugural HKEC Board beyond 2003. The matter should be reviewed in, say, 2002, by the HKEC Board before a final decision is made.

The HKEC Directors draw to the attention of Stock Exchange Shareholders that the chairman of the preparatory HKEC Board is Mr. Charles Lee. It is provided in the Position Paper that subsequent chairmen will be elected by the HKEC Directors, subject to endorsement by the Chief Executive of Hong Kong. The HKEC Board will be empowered to remove the chairman by a two-thirds majority vote and the Chief Executive of Hong Kong may remove him on grounds of public interest or the interests of the investing public. Each chairman will be appointed for a three year term and may serve a maximum of two consecutive terms, assuming re-election.

The HKEC Directors draw to the attention of Stock Exchange Shareholders that the directors of the preparatory HKEC Board, additional to the chairman, comprise Mr. Rafael Hui, Mr. Dannis Lee and Mr. John Strickland. It is provided in the Position Paper that the HKEC Board (following the preparatory HKEC Board) will, as described above, comprise HKEC Directors returned by HKEC shareholders, HKEC Directors appointed by the Government representing the public and market interests and the CEO as an ex-officio member. Each HKEC Director will serve a three year term and may be re-appointed or re-elected for further terms.

Details of the experience and qualifications of HKEC Directors are set out in appendix I to this document under the heading "Directors".

The CEO and the COO will be appointed by the HKEC Board on the recommendation of the chairman, subject to approval by the SFC. The HKEC Board will be able to remove the CEO or COO by a simple majority upon a recommendation from the chairman, and the SFC may remove the CEO or COO on grounds of public interest or the interest of the investing public after consultation with the chairman and the Financial Secretary of Hong Kong (subject, in the case of removal by the SFC, to appeal to the Chief Executive of Hong Kong).

LETTER FROM HKEC

It is envisaged in the Position Paper that HKEC will also have the governance committees and consultative panels referred to in the table below, which committees and panels will include external members as indicated in the table:

HKEC BOARD COMMITTEES AND PANELS			
	Committees	Key tasks	Composition
Governance committees:	Audit	<ul style="list-style-type: none"> • Review financial statements before HKEC Board • Nominate external auditors • Monitor the structure of internal controls 	<ul style="list-style-type: none"> • 3 HKEC Directors (including 1 as chairman) • 3 to 5 external members (appointed by HKEC Board)
	Risk management	<ul style="list-style-type: none"> • Review risk management procedures • Assess changes in minimum capital reserve requirement, margining levels, counterparty risk limit 	<ul style="list-style-type: none"> • 3 HKEC Directors (including 1 as chairman) • 3 to 5 external members including cross-market government experts and public interest representatives (appointed by the HKEC Board)
	User appeal	<ul style="list-style-type: none"> • Adjudicate disciplinary matters concerning participants and listed companies 	<ul style="list-style-type: none"> • 1 HKEC Director • 5 to 6 external market professionals (e.g. lawyers, accountants) • 2 to 3 public interest representatives
	Listing matters	<ul style="list-style-type: none"> • Adjudicate appeals on listing decisions and other listing matters 	<ul style="list-style-type: none"> • 1 HKEC Director • 5 to 6 external market professionals (e.g. lawyers, accountants) • 2 to 3 public interest representatives
Consultative panels:	Cash market	<ul style="list-style-type: none"> • Provide market expertise on : 	<ul style="list-style-type: none"> • 10 members for each panel of which 2 are HKEC Directors
	Derivatives market	<ul style="list-style-type: none"> - International trends - Intermediary / issuer / investor needs - Technology challenges - New product opportunities 	<ul style="list-style-type: none"> • Selected from representatives of market participants and industry experts
	Clearing	<ul style="list-style-type: none"> • Act as sounding board for <ul style="list-style-type: none"> - Policy decisions - Strategic initiatives - Major investments 	<ul style="list-style-type: none"> • Selection process to be determined

(d) Shareholding limit

The HKEC Directors draw to the attention of Stock Exchange Shareholders that, in response to the proposals contained in the Position Paper, it is provided in the draft new Articles of Association of HKEC that no person will be permitted to have an interest in more than 5 per cent. of the votes that could be cast on any resolution at any general meeting of HKEC unless they fall within one of the categories of permitted person. Such categories of permitted person include a person who has obtained a waiver from the provisions of the new Articles of Association from the SFC in consultation with the Financial Secretary of Hong Kong. A summary of the relevant provisions of the draft new Articles of Association of HKEC is set out on pages 172 to 182 in appendix V to this document.

It is provided in the Position Paper that any changes in the corporate structure of the HKEC Group involving changes in the equity ownership of HKEC's subsidiaries will require the approval of the SFC in consultation with the Financial Secretary of Hong Kong.

BUSINESS OF THE HKEC GROUP

Upon completion of the Overall Proposal, the business of the HKEC Group will consist of the businesses of the Stock Exchange Group (described in the Explanatory Statement), the Futures Exchange Group and the HKSCC Group. Set out below and in appendices III, IV and VIII to this document are brief descriptions of and information relating to the Futures Exchange Group and the HKSCC Group provided by the relevant companies and/or reproduced from publicly available information. The HKEC Directors have not independently verified such descriptions and information. Additionally, the HKEC Directors have not yet considered whether any fixed assets of the Stock Exchange Group, Futures Exchange Group or the HKSCC Group will be redeployed as a result of the Overall Proposal.

(a) The Futures Exchange Group

(i) Business of the Futures Exchange Group

Established in 1976, the Futures Exchange is a derivatives market leader in the Asia Pacific region. The Futures Exchange provides efficient and diversified markets for the trading of futures and options contracts by its more than 130 members, including many that are affiliated with international financial institutions. The Futures Exchange operates futures and options markets on a broad range of products including equity index, stock, interest rate and currency products traded by open outcry and electronically on the automated trading system ("HKATS"). The Futures Exchange, with its subsidiary HKFECC, operates a rigorous risk management system, enabling members and their clients to meet their respective investment and hedging needs in a liquid and well regulated marketplace.

Whilst it was originally proposed that the trading of Hang Seng Index futures and options contracts ("HSI contracts") would migrate from open outcry to electronic trading on HKATS by 2nd August, 1999, no definitive date for such migration has yet been set. However, it is expected that the migration will occur in 1999 or the year 2000. The board of directors of the Futures Exchange believes that the timing of the migration, whether it occurs in 1999 or the year 2000, will not cause any material disruption to the business of the Futures Exchange or to the markets for HSI contracts.

(ii) Financial information for the Futures Exchange Group

The principal sources of the Futures Exchange's income are interest income and transaction and clearing fees. Interest income amounted to HK\$570.3 million for the year ended 30th June, 1999 and represented 76.4 per cent. of total revenue. Transaction and clearing fees were HK\$136.6 million for the year ended 30th June, 1999, representing 18.3 per cent. of total revenue. Other income comprised mainly price reporting income.

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Set out in appendix III to this document are the special purpose accounts of the Futures Exchange Group for the year ended 30th June, 1999, the balance sheets of the Futures Exchange and the Futures Exchange Group as at 30th June, 1999 and the consolidated cash flow statement of the Futures Exchange Group for the year ended 30th June, 1999.

(b) The HKSCC Group

(i) Corporate Structure

HKSCC is presently incorporated in Hong Kong as a company limited by guarantee. The guarantors are Bank of China, The Bank of East Asia, Limited, Hang Seng Bank Limited, The Hongkong and Shanghai Banking Corporation Limited and Standard Chartered Bank (each of whom provides 10 per cent. of the guarantee of HKSCC and up to an amount of HK\$5,000,000 each) and the Stock Exchange (which provides 50 per cent. of the guarantee of HKSCC and up to an amount of HK\$25,000,000).

Pursuant to the Enabling Legislation, HKSCC will become a company limited by shares and a wholly owned subsidiary of HKEC. Also pursuant to the Enabling Legislation, the guarantees provided by the current guarantors will be released. Separately a guarantee for an equivalent aggregate amount will be granted by HKEC.

(ii) Business of the HKSCC Group

CCASS

HKSCC is a recognised clearing house under the Clearing Houses Ordinance and operates CCASS. Within CCASS, delivery and receipt of securities is effected via electronic debits and credits with HKSCC operating as the settlement counterparty for Stock Exchange trades settled on a continuous net settlement ("CNS") basis.

HKSCC employs a range of risk management measures including marking-to-market of outstanding CNS positions, the ability to effect real time delivery versus payment settlement, and the maintenance of a back up guarantee fund. As at 30th June, 1999 the guarantee fund, inclusive of excess insurance coverage and contributions by HKSCC, stood at approximately HK\$848 million and, in addition, HKSCC had standby facilities for an aggregate amount of HK\$1.1 billion to provide additional liquidity to meet its obligations in CCASS in circumstances where participants default in their payment obligations.

Since October 1997, CCASS has had the capacity to handle up to 550,000 Stock Exchange trades per day.

A disaster recovery system is operated that simultaneously updates data in both the primary and backup computer systems and allows a recovery time from a system failure of under two hours.

CCASS is essentially Year 2000 compliant by design. It uses four-digit years for all dates internally and in all external data file interfaces. The associated risks are

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assessed to be low and contained in nature. Nevertheless, HKSCC has participated in industry-wide efforts to ensure Year 2000 compliance. HKSCC has also prepared contingency plans for any disruption in CCASS operation caused by major business partners and intermediary participants.

As at 30th June, 1999, HKSCC had 319 staff.

HKSCC Registrars Limited

HKSCC Registrars Limited, a wholly owned subsidiary of HKSCC, provides registrar services to listed companies in Hong Kong. As at 30th June, 1999, it was acting as the registrar to 47 such companies.

(iii) *Financial information for the HKSCC Group*

HKSCC's income comes primarily from the fees it charges to CCASS participants. The majority of its income is derived from stock clearing and settlement fees, depository, custody and nominee services fees and registration and transfer fees for nominee services.

Set out in appendix IV to this document are the consolidated income and expenditure account of the HKSCC Group for the year ended 30th June, 1999, the balance sheets of HKSCC and the HKSCC Group as at 30th June, 1999 and the consolidated cash flow statement of the HKSCC Group for the year ended 30th June, 1999. Also included in appendix IV to this document are the operating statement and cash flow statement of the guarantee fund for the year ended 30th June, 1999 and the balance sheet of the guarantee fund as at 30th June, 1999.

(iv) *United Kingdom Stamp Duty Reserve Tax*

HKSCC was contacted by the Stamp Office of the United Kingdom Inland Revenue in 1998 seeking information about how the share dealing systems in Hong Kong currently work in order to establish whether any transfers of shares of United Kingdom ("UK") incorporated companies into CCASS would trigger a liability to United Kingdom Stamp Duty Reserve Tax ("UK SDRT").

UK SDRT is a tax on agreements to transfer chargeable securities (which broadly refers to shares or securities of UK incorporated companies) for money or money's worth unless there is an existing instrument of transfer duly chargeable to UK stamp duty or the agreement is exempted therefrom. UK SDRT is a different tax from the normal UK stamp duty and is intended to remedy UK stamp duty avoidance on paperless transfers of shares without the use of written instruments of transfer, e.g. transfers under an electronic clearing system. UK SDRT has specific application to clearance services in that UK SDRT is triggered whenever chargeable securities are transferred or issued to the clearance service provider or its nominee. As a result of legislative enactment in the UK, as from 1st July, 1996, UK SDRT can apply to overseas transfer agreements, whether or not the transactions are effected in the UK and whether or not any party to the transfer is resident in the UK.

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The HKSCC Group has not received any further enquiries from the UK Inland Revenue Stamp Office after the latter's initial requests for information in 1998. No demand for UK SDRT has been received by the HKSCC Group to date and the HKSCC Group is not aware of any legal action taken by the authorities in the UK in this respect to date. HKSCC has requested the assistance of the Government to raise the issue with the relevant UK authorities in order to obtain a satisfactory outcome.

On the basis of legal opinions obtained from UK Queen's Counsel, the HKSCC Group will not have to make any payment for UK SDRT or suffer any penalty in respect thereof.

FINANCING OF THE STOCK EXCHANGE CASH ALTERNATIVE

The Stock Exchange Cash Alternative and the Futures Exchange Cash Alternative will be financed by HKEC from (a) facilities for HK\$600.0 million in aggregate arranged by HKEC with The Hongkong and Shanghai Banking Corporation Limited, Bank of China and Standard Chartered Bank and (b) loans of up to HK\$669.0 million and up to HK\$77.0 million from the Stock Exchange and the Futures Exchange, respectively. The loans from the Exchanges will be advanced pursuant to funding letters entered into by each of the Exchanges with HKEC on 30th July, 1999 under which the Stock Exchange and the Futures Exchange have agreed to maintain amounts of HK\$669.0 million and HK\$77.0 million, respectively, as reserves which will not be utilised for any purpose other than making the advances to HKEC. The advance of a loan by the Stock Exchange is subject to the sanction of the Court and the Stock Exchange Scheme becoming effective. The advance of a loan by the Futures Exchange is similarly subject to the sanction of the Court and to the Futures Exchange Scheme becoming effective. The principal terms of the loans from the Exchanges will be as follows:

- Term: 4 years;
- Interest: 1.25% per annum over 3 months HIBOR per annum;
- Drawdown: on or before 31st March, 2000;
- Repayment: in full by the end of the term by 16 equal quarterly instalments; and
- Prepayment: HKEC may prepay at any time.

Repayments of principal and payments of interest in respect of the above financing for HKEC will be financed, in whole or in part, by monies made available (whether by dividends and/or advances) from the Exchanges.

HKEC's Financial Adviser is satisfied that sufficient financial resources are available to HKEC to satisfy HKEC's obligations with regard to the Stock Exchange Cash Alternative.

PROSPECTS OF THE HKEC GROUP

It is provided in the Position Paper that, in order to achieve a sustainable competitive position, HKEC will need to have high aspirations, institute a performance and shareholder driven culture, align resources against clear strategic priorities, develop new product and service lines and achieve regional leadership in technology.

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Set out below in this section headed "Prospects of the HKEC Group", save where otherwise indicated, is a summary of the provisions of the Position Paper in regard to each of these matters. Accordingly, save where expressly stated as being those of the HKEC Directors, all views, intentions and opinions expressed in this section are those of the Government.

The HKEC Directors draw to the attention of Stock Exchange Shareholders that they are at an early stage in their consideration of what will be necessary in order for HKEC to achieve a sustainable competitive position. However, the HKEC Directors have currently not identified any issues on which their views differ materially from the Position Paper in this regard.

(a) Setting high performance aspirations

HKEC should strive to achieve the following medium term aspirations:

To be the Asian-time-zone pillar of the global futures and derivative markets and one of the top five equities markets in the world. As the natural international market to meet mainland China's enormous demand for capital, HKEC has the potential to be at the core of the financial centre of Asia and one of the pre-eminent equities markets globally. Non-domestic listings could reach 30-40 per cent. of total listings, including a large share of mainland China's issuers. Over the next five years, Hong Kong's market capitalisation stands to increase substantially as listed companies benefit from economic recovery and are well positioned to tap the faster growth of emerging market economies. Trading volume is likely to be supported by a growing number of regional and global investors who could supply as much as 50 per cent. of trading volume (compared with about 30 per cent. currently). Mainland China investors can become a significant source of new funds and trading volume. The growth and diversification of the local equities market will help underpin Hong Kong's corresponding bid for regional leadership in the global futures and derivatives markets.

Continuing development of debt and money markets in Hong Kong, in mainland China and across Asia in the coming five years will provide further opportunities for HKEC to develop regional currency and interest-rate futures and derivatives. HKEC can augment regional developments by drawing upon global investors' increasing desire to trade around the clock. By facilitating increased liquidity in regional instruments, leveraging its time-zone position, and promoting broader access, HKEC can aspire to trade in global futures and derivatives products to become the Asian linchpin in global 24-hour investment flows.

To be the Asian center of excellence for exchange-related technology, regulation and services. To secure its leadership, HKEC must aspire to be at the forefront of exchange developments in Asia. HKEC must thrive on innovation and remain responsive to users' needs and competitive threats. By remaining ahead of the game in technology, regulation and new value-added services, HKEC can serve as a model for development of the securities and futures markets in Asia.

With these aspirations, HKEC will aim to become the preferred Asian partner for other major equities and derivatives exchanges seeking to build global alliances and should increasingly attract top management talent from the region. Success in these changes will reinforce HKEC's attractiveness to the regional headquarters of fund management firms, investment banks, stockbrokers (including mainland China securities firms) and information providers. HKEC will have to act rapidly against these aspirations to set itself among the

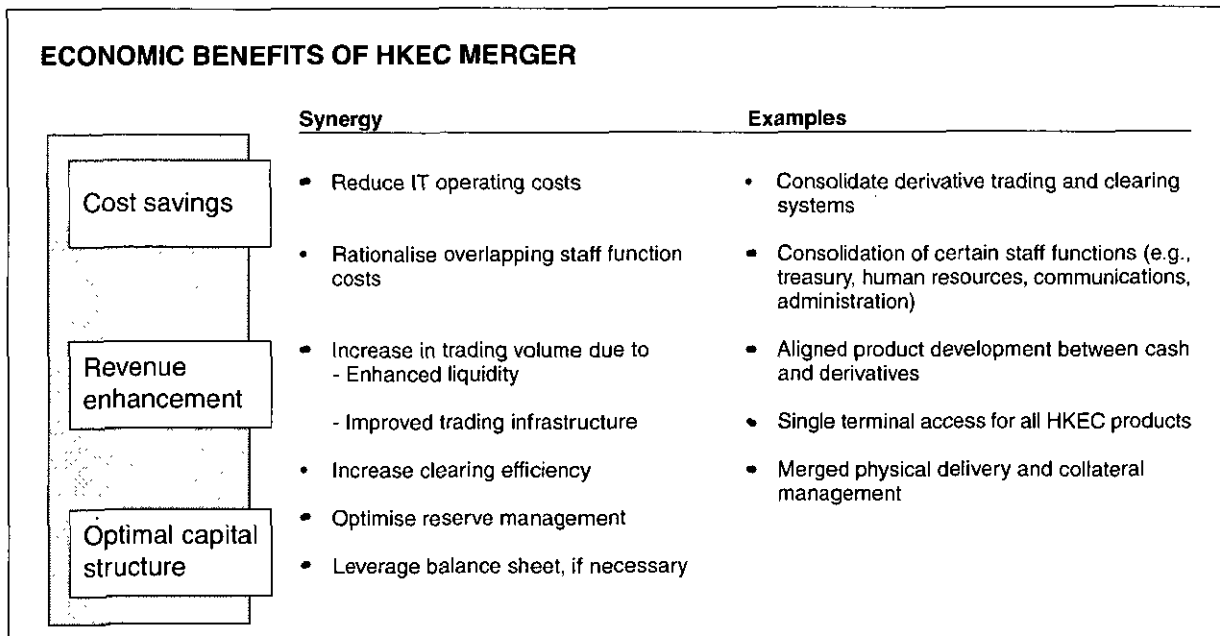
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leaders on the global playing field, starting from a position where, according to the Explanatory Statement, the Stock Exchange was ranked tenth globally in terms of the market capitalisation as at 30th June, 1999. Also, the Futures Exchange is ranked below the top 20 in derivatives in terms of the number of contracts traded.

(b) Developing performance and shareholder driven culture

HKEC will need to develop a commercially and performance oriented culture that is reinforced by a management focus on creating shareholder value and long term business potential. To develop a high performance culture amongst all staff, the entire organisation will first have to become client driven. To ensure consistent performance, HKEC will need to focus on profit and growth. An emphasis on profitability will require continuous efforts to improve productivity and reduce costs. While start-up investment for new product development will continue to be needed, structural cross-subsidies must be removed so that each product area can be measured for contribution. However, in areas critical to public interest, such as clearing, profit will remain a secondary objective and risk management measures will have to be strictly observed. Sharpened focus on profitability will have to be accompanied by efforts to capture new growth opportunities, including through alliances with other exchanges and, it is possible in the longer term, equity investments in and acquisition of other exchanges and clearing houses.

Three main sources of enhanced economic and financial performance will be available to HKEC as a result of the Overall Proposal:



(c) Building a team of excellence

HKEC should develop a human resources plan that reinforces a meritocracy in which staff recruitment, promotion and compensation are aligned with performance targets and achievements. The plan should enable HKEC to build on the existing strength of the staff of

the Exchanges and Clearing Houses and to draw on external expertise where necessary. Existing staff of the Exchanges and Clearing Houses will face both opportunities and challenges, and will need to be able to adapt to the new business culture of HKEC, a more integrated market environment and a strong international orientation in business development.

(d) Clear strategic priorities

HKEC must aggressively expand its client base. This will involve:

- *expanding its investor base* - it is important that HKEC maintains a diversified client base of domestic retail investors, domestic institutional investors and international institutional investors. To achieve this, HKEC should actively look for opportunities to increase the participation of *domestic retail investors*, by contributing to their education on the attractiveness of direct and indirect securities (unit trusts) and derivatives investment opportunities. *Regional and international investor* relationships can be broadened by systematically promoting regional products and remote trading access to intermediaries and potentially directly to both institutional and retail clientele. *Mainland China investors* can become a significant component of HKEC's client base given their growing investment needs and appetite.
- *broadening the issuer base* - HKEC can "specialise" in mainland China listings and develop systematic promotional efforts with listing candidates to make HKEC the clear favourite for international listing over any other global markets. *The Hong Kong issuer base* can also be expanded by upgrading efforts to promote listings on the Growth Enterprise Market (GEM) and by working with relevant government bodies in the process of privatising and increasing the float of government-owned companies. Finally, *regional and international issuers* can be attracted by promoting Hong Kong as Asia's capital market hub that provides the best exposure to the growing Asian institutional investor base.
- *diversifying and customising market access* - expanding access, as described above, to new intermediaries in Hong Kong and abroad, increasing possibilities for market participants to select which individual trading and/or clearing facilities they wish to access, allowing clearing facilities to be accessed by clients wanting clearing and/or settlement services only and segmenting access criteria and pricing based on the type of user, individual trading or clearing facilities, and the access channel used (e.g. local versus remote). HKEC may offer bundled pricing for access to multiple sub-markets to attract multi-product volume intermediaries and investors. Pricing for segmented access should be a commercial decision, with pricing differentiated to reflect varying levels of counterparty risk, cost and market demand.

(e) Upgrading and diversifying products and services

Opportunities for HKEC lie in, among other things:

- *introducing new investment instruments* - to increase the attractiveness of Hong Kong's markets to intermediaries and investors;
- *developing new business lines* - in clearing and settlement services, information sales and analysis and technology services;

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- *aligning market models* - including clearer segmentation and grouping of related stocks into specific themes, providing a hybrid trading model to optimally match issuer profiles with investor trading patterns and extending trading hours; and
- *refocusing and upgrading regulatory services* - which will provide it with a competitive advantage, through the imprimatur of a "badge of quality", over pure technology platforms.

(f) **Developing state-of-the-art technology and systems**

Leading exchanges are increasingly focusing on technology solutions to address growing market user demands. HKEC's technology and system choices not only determine functionality but influence which other global exchanges it may be strategically and technologically linked with in a global trading network. The merger of the Exchanges and HKSCC into HKEC, which will bring today's different systems under one roof, provides an unprecedented opportunity to consolidate and upgrade capabilities.

A project under the Steering Committee on the Enhancement of Financial Infrastructure ("SCEFI"), scheduled to be completed in September 1999, will help shape and detail HKEC's technology agenda. The SCEFI has been set up by the Financial Secretary of Hong Kong to study and make recommendations as to how the financial infrastructure in Hong Kong could be enhanced. Major issues to be examined include: the setting up of a single clearing arrangement for securities, stock options and futures transactions; the enhancement of straight through processing across the financial markets; and the introduction of a secure, scripless securities market. SCEFI is chaired by the Chairman of the SFC with members from the Hong Kong Monetary Authority, the Information Technology and Broadcasting Bureau, the Stock Exchange, SEOCH, HKSCC, the Futures Exchange, HKFECC, the SFC, Hong Kong Information Technology Federation and the Financial Services Bureau of the Government.

LISTING OF HKEC SHARES

Set out below in this section headed "Listing of HKEC Shares" save where otherwise indicated, is a summary of the provisions of the Policy Paper and the Position Paper regarding the listing of HKEC Shares. The HKEC Directors agree with all of these provisions.

HKEC Shares should be listed on the Stock Exchange at the earliest practicable opportunity so as to enable the shareholders of HKEC to have a ready market for their HKEC Shares. The timing of the listing may depend on the extent to which any reorganisation of the operations of HKEC, the Stock Exchange Group, the Futures Exchange Group and the HKSCC Group is effected prior to listing. Listing will, however, be targeted for as soon as practicable thereafter, hopefully by 30th September, 2000. The HKEC Directors draw to the attention of Stock Exchange Shareholders that it is presently intended that the listing of HKEC Shares on the Stock Exchange will be by way of an introduction and will not involve any fund-raising. Accordingly, the timing of the listing should not be particularly sensitive to market conditions.

As a publicly listed company, HKEC will be able to raise capital more flexibly than a mutual association since it will be able to access the capital markets. Access to such funding will be essential given the increasing financial burdens facing the Exchanges, arising from the need to provide users with state-of-the-art trading and settlement systems, as described above under the heading "Background To, and Reasons For, the Overall Proposal".

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A public listing will also promote truly public ownership and encourage market operators to subject themselves to transparency, accountability and market discipline.

Through the listing, the Stock Exchange will gain a listed company which will be a new world-class, professionally run financial institution that will broaden the investment base of quality companies in Hong Kong.

HKEC, as a listed company on its own stock market, will be regulated by the SFC to avoid a conflict of interest and to ensure a level playing field between HKEC and other listed companies which will be subject to the listing rules administered by HKEC.

The HKEC Directors also draw to the attention of Stock Exchange Shareholders that it is proposed by HKEC to explore the feasibility of establishing a mechanism for matching, during the period following the Effective Date and prior to the HKEC Shares being listed, potential purchasers of HKEC Shares with potential sellers.

THE WAY FORWARD

As envisaged in the Position Paper, during the transitional period between the approval of the Stock Exchange Proposal and the Futures Exchange Proposal by the shareholders of the respective Exchanges and the Effective Date, the Exchanges and Clearing Houses are expected by Government to operate as they are currently. During that period, it is also expected by Government that the HKEC Board will be expanded to include one representative from each of the Stock Exchange, the Futures Exchange and HKSCC. It is envisaged in the Position Paper that this expanded preparatory HKEC Board will focus on the necessary preparatory work for the implementation of the merger and the coming into operation of HKEC, including staff planning for HKEC and the continued employment of the employees of the Stock Exchange Group, the Futures Exchange Group and the HKSCC Group and any necessary transitional arrangements and appropriate corporate communications plans. While the Position Paper provides the Government's views and proposals for HKEC, in many cases the final decision on the method, timing and form of implementing such proposals has been left to the HKEC Board, the composition of which will change over time as indicated in the Position Paper. *Stock Exchange Shareholders should note that the proposals (except, for the avoidance of doubt, the provisions relating to Trading Rights set out in paragraphs (a) to (d) above under the heading "Relevant Material Aspects of the Market Reforms") contained in this Letter from HKEC are subject to modification or amendment.*

Yours faithfully
For and on behalf of
Hong Kong Exchanges and Clearing Limited
Charles Lee
Chairman

EXPLANATORY STATEMENT

**This explanatory statement constitutes the statement required
under section 166A of the Companies Ordinance**

INTRODUCTION

This Explanatory Statement summarises the terms and effects of the Stock Exchange Proposal.

A letter from the Council is set out on pages 7 to 13 of this document. A letter of advice to the Council from the Independent Financial Adviser in connection with the Stock Exchange Proposal is set out on pages 14 to 28 of this document. Further information from HKEC on, among other things, the background to and reasons for the Overall Proposal, relevant aspects of the market reforms and the HKEC Group and its prospects is set out in the Letter from HKEC on pages 29 to 54 of this document, to which the Stock Exchange Shareholders are referred.

BUSINESS OF THE STOCK EXCHANGE GROUP

(a) Operations

The Stock Exchange has since 1981 been recognised as the "Exchange Company" within the meaning of the Stock Exchanges Unification Ordinance. The objects of the Stock Exchange include the establishment and operation of a single, unified stock exchange in Hong Kong and the provision of a central clearing system. As at 30th June, 1999, the market capitalisation of listed equities was approximately HK\$3,590 billion, and Hong Kong ranked tenth in the world and second in Asia by market value of shares of domestic listed companies.

Instruments listed and traded on the Stock Exchange include equities, warrants, debt securities, unit trusts and stock options. As at 30th June, 1999, the Stock Exchange had 688 listed companies, including 42 mainland Chinese companies. The Stock Exchange continues to expand its services as a capital formation centre by expanding its product range and improving the market infrastructure. To this effect, the Stock Exchange plans to launch the Growth Enterprise Market and on 16th August, 1999 commenced the trading of Exchange Fund Notes.

(b) Financial information for the Stock Exchange Group

The principal sources of the Stock Exchange's income are transaction levy, stock information income and listing fees. In the fiscal year ended 30th June, 1999, transaction levy accounted for 25.3 per cent. of turnover, stock information income for 23.8 per cent. and listing fees for 22.3 per cent. Other income comprised mainly interest income and income from members.

Set out in appendix II to this document are the consolidated statement of operations and retained surplus of the Stock Exchange Group for the year ended 30th June, 1999, the balance sheets of the Stock Exchange and the Stock Exchange Group as at 30th June, 1999 and the consolidated cash flow statement of the Stock Exchange Group for the year ended 30th June, 1999.

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BACKGROUND TO, AND REASONS FOR, THE OVERALL PROPOSAL

The proposal for the merger of the Stock Exchange, the Futures Exchange and HKSCC, as part of a comprehensive reform of the securities and futures markets in Hong Kong, was announced by the Financial Secretary of Hong Kong in his Budget Speech of 3rd March, 1999. The background to, and reasons for, the Overall Proposal are set out in detail in the Letter from HKEC.

THE STOCK EXCHANGE PROPOSAL

(a) Manner of implementation

It is proposed that the Stock Exchange Proposal be implemented by a scheme of arrangement, under section 166 of the Companies Ordinance. The Stock Exchange Scheme will also involve a reduction of the share capital of the Stock Exchange and the provision of a loan of up to HK\$669.0 million from the Stock Exchange to HKEC. The Stock Exchange Scheme is set out on pages 192 to 199 of this document.

(b) Cancellation Consideration

Upon the Stock Exchange Scheme becoming effective it will be binding on the Stock Exchange and all Stock Exchange Shareholders. The Stock Exchange Scheme Shares will be cancelled and, in consideration for the cancellation, Stock Exchange Shareholders will be entitled to receive 747,845,000 HKEC Shares in aggregate. The Stock Exchange Scheme also offers Stock Exchange Shareholders the Stock Exchange Cash Alternative, which will be funded by bank borrowings of HKEC and internal resources of the Exchanges.

Accordingly, on the basis of the 929 Stock Exchange Shares in issue, each Stock Exchange Shareholder will be entitled to receive:

For each Stock Exchange Scheme Share held 805,000 HKEC Shares

The HKEC Shares which are to be issued to Stock Exchange Shareholders will rank *pari passu* in all respects with the two HKEC Shares presently in issue and which are beneficially owned by The Financial Secretary Incorporated and with the HKEC Shares which are to be issued in connection with the Futures Exchange Proposal.

Furthermore, under the Stock Exchange Cash Alternative, Stock Exchange Shareholders may elect on or before the Election Deadline to receive HK\$3.88 in cash for each HKEC Share in place of all or some of the HKEC Shares to which they become entitled under the Stock Exchange Scheme, subject to an overall aggregate limit of HK\$935.2 million (i.e. the Stock Exchange Cash Limit). On the basis of the 929 Stock Exchange Shares in issue, the Stock Exchange Cash Limit of HK\$935.2 million will enable 259,452 HKEC Shares to be replaced by cash (equivalent to HK\$1,006,673.76 in aggregate) for every Stock Exchange Scheme Share held. Accordingly, on this basis, under the Stock Exchange Scheme, a Stock Exchange Shareholder who elects for the Stock Exchange Cash Alternative up to a level of 259,452 HKEC Shares for each Stock Exchange Scheme Share held will have his election satisfied in full and will receive at least 545,548 HKEC Shares and up to HK\$1,006,673.76 in cash, depending on the size of the election, for each Stock Exchange Scheme Share in respect of which an election is made. In the event that a Stock Exchange Shareholder submits an election

EXPLANATORY STATEMENT

in respect of more than 259,452 HKEC Shares for each Stock Exchange Scheme Share held, the amount of cash in excess of the sum of HK\$1,006,673.76 to which he will be entitled will be dependent on the remaining balance of the Stock Exchange Cash Limit, if any. Any balance so available will be shared amongst such Stock Exchange Shareholders in place of HKEC Shares in the proportion that the size of the excess election made by each such Stock Exchange Shareholder in respect of each Stock Exchange Share bears to the total excess elections made by all Stock Exchange Shareholders, provided however that the amount paid to each Stock Exchange Shareholder shall be rounded down to the nearest whole multiple of HK\$3.88.

In the event that the aggregate amount of elections for the Stock Exchange Cash Alternative does not exceed the Stock Exchange Cash Limit, a Stock Exchange Shareholder who elects to receive cash in respect of all of the HKEC Shares to which he becomes entitled under the Stock Exchange Scheme will receive, on the basis of the 929 Stock Exchange Shares in issue, HK\$3,123,400 in cash (equivalent to 805,000 HKEC Shares) for each Stock Exchange Scheme Share held, and no HKEC Shares.

The assured cash entitlement of each Stock Exchange Scheme Share is therefore HK\$1,006,673.76 on the basis set out above. If every Stock Exchange Shareholder makes an election to receive the Stock Exchange Cash Alternative equal to or in excess of the level of his assured cash entitlement, each Stock Exchange Shareholder will only receive the assured amount in cash and the rest of his entitlement will be in the form of HKEC Shares.

The entitlement of Stock Exchange Shareholders to HKEC Shares and/or to cash under the Stock Exchange Cash Alternative would need to be adjusted downwards if further Stock Exchange Shares were issued before the Effective Date. However, the Council has no authority to issue further Stock Exchange Shares without the approval of Stock Exchange Shareholders in general meeting, and does not intend to seek such approval.

The Election Deadline will be notified to Stock Exchange Shareholders by the Stock Exchange in writing at least 14 days in advance, which date will also be announced in the Newspapers. An election must be made by completing a Form of Election. The Election Deadline will be not less than 7 days before the Effective Date.

Upon the Stock Exchange Scheme becoming effective, all the Stock Exchange Scheme Shares will be cancelled. On restoration of its authorised share capital to its original amount, the Stock Exchange will then issue in aggregate to HKEC and its nominee a number of Stock Exchange Shares equivalent to the number cancelled. The Stock Exchange Shares will be issued to HKEC and its nominee, credited as fully paid, by applying the credit arising from the cancellation of the Stock Exchange Scheme Shares.

The Stock Exchange Scheme will lapse if the Effective Date does not occur on or before 31st March, 2000 or such later date as the Court may allow. Should that occur, Stock Exchange Shareholders will be notified by the Stock Exchange in writing accordingly, and an announcement thereof will also be placed in the Newspapers.

EXPLANATORY STATEMENT

CONDITIONS OF THE STOCK EXCHANGE PROPOSAL

The Stock Exchange Proposal will become effective and binding on the Stock Exchange and all Stock Exchange Shareholders provided that all of the following conditions are fulfilled:

- (a) the approval of the Stock Exchange Scheme by a majority in number, representing not less than three-fourths in value, of the Stock Exchange Scheme Shares that are voted either in person or by proxy at the Court Meeting;
- (b) the passing of appropriate resolutions to approve and give full effect to the Stock Exchange Scheme, the Stock Exchange Proposal and all matters ancillary thereto (including the reduction of the capital of the Stock Exchange involved in the Stock Exchange Scheme, the modification of the objects clause of the Memorandum of Association of the Stock Exchange and the adoption of new Articles of Association of the Stock Exchange) at the Extraordinary General Meeting of the Stock Exchange and such resolutions remaining in effect;
- (c) the sanction of the Stock Exchange Scheme (with or without modification), and the confirmation of the reduction of the share capital of the Stock Exchange, by the Court;
- (d) the enactment of the Enabling Legislation;
- (e) the Futures Exchange Proposal taking effect no later than the time at which the Stock Exchange Proposal becomes effective; and
- (f) the registration by the Registrar of Companies in Hong Kong of an office copy of the order of the Court in respect of the Stock Exchange Scheme, together with the minute containing the particulars required by section 61 of the Companies Ordinance.

The condition in paragraph (d) above will be deemed to be satisfied provided that a certificate is issued to the Exchanges by the Financial Secretary of Hong Kong certifying that the condition has been satisfied.

The condition in paragraph (e) above will be deemed to be satisfied provided that an office copy of an order of the Court sanctioning the Futures Exchange Scheme, together with a minute containing the particulars required by section 61 of the Companies Ordinance, is registered by the Registrar of Companies in Hong Kong on the day on which the condition in paragraph (f) above is satisfied.

Assuming that the Conditions are fulfilled, it is expected that the Effective Date will be on or before 31st January, 2000. Stock Exchange Shareholders will be notified by the Stock Exchange in writing, at the appropriate time, of the Transfer Approval Deadline, the Election Deadline and the Effective Date, which dates will also be announced in the Newspapers.

EXPLANATORY STATEMENT

FUNDING FOR THE STOCK EXCHANGE CASH ALTERNATIVE

As described in the Letter from HKEC, the Stock Exchange Cash Alternative and the Futures Exchange Cash Alternative will be financed by HKEC from facilities from its banks and loans of up to HK\$669.0 million and up to HK\$77.0 million from the Stock Exchange and the Futures Exchange, respectively. The loans from the Exchanges are terms of the Stock Exchange Scheme and the Futures Exchange Scheme, respectively, and unless otherwise approved by the Court as part of the relevant scheme could constitute unlawful financial assistance by the Exchanges for the acquisition of their shares. The funding letter pursuant to which the loan is to be advanced by the Stock Exchange is available for inspection as referred to in appendix VIII to this document.

The Stock Exchange has agreed with HKEC to maintain an amount of HK\$669.0 million as a reserve not available for any purpose in the business of the Stock Exchange other than for the purpose of making available funding to HKEC.

As at 30th June, 1999 the Stock Exchange had cash reserves surplus to its working capital requirements in excess of HK\$669.0 million and the Council considers that it is in the interests of Stock Exchange Shareholders (and not prejudicial to the interests of creditors of the Stock Exchange) that the funding be made available to HKEC for the purposes of the Stock Exchange Cash Alternative and the Futures Exchange Cash Alternative.

THE OVERALL PROPOSAL

Simultaneously with the Stock Exchange Scheme taking effect, the Futures Exchange Scheme will also take effect. Pursuant to the Enabling Legislation, HKSCC will become a company limited by shares and a wholly owned subsidiary of HKEC. The current members of HKSCC, being the Stock Exchange and five commercial banks, will be released from the guarantees they have given in respect of HKSCC's liabilities. They will not receive any HKEC Shares.

Upon completion of the Overall Proposal, the Stock Exchange, the Futures Exchange and HKSCC will all be wholly owned subsidiaries of HKEC.

For the avoidance of doubt, other than the Stock Exchange Cash Alternative, the Overall Proposal does not include any option whereby Stock Exchange Shareholders can require HKEC, the Government or anyone else, to acquire HKEC Shares (and/or Stock Exchange Trading Rights) for cash. Similarly, no such options (other than the Futures Exchange Cash Alternative) are being granted to Futures Exchange Shareholders.

COMPARISON WITH THE FUTURES EXCHANGE PROPOSAL

Upon the Futures Exchange Proposal becoming effective, Futures Exchange Shareholders will be entitled to receive 320,505,000 HKEC Shares in aggregate. Accordingly, on the basis of the 230 Futures Exchange Shares in issue, each Futures Exchange Shareholder will be entitled to receive 1,393,500 HKEC Shares in consideration for every Futures Exchange Share cancelled.

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The Futures Exchange Proposal offers Futures Exchange Shareholders the Futures Exchange Cash Alternative. Under the Futures Exchange Cash Alternative, Futures Exchange Shareholders may elect to receive HK\$3.88 in cash per HKEC Share in place of all or part of the HKEC Shares to which they become entitled under the Futures Exchange Proposal, subject to an overall aggregate limit of HK\$400.8 million (i.e. the Futures Exchange Cash Limit).

In the event that the shareholders of one Exchange do not elect, pursuant to the cash alternative available to them, to receive cash up to the aggregate cash limit applicable to them, the unused cash will not be applied towards the cash alternative available to the shareholders of the other Exchange.

The Cancellation Consideration represents an exchange ratio as between Stock Exchange Shareholders and Futures Exchange Shareholders, respectively, of 70:30 in terms of (a) the total number of HKEC Shares that could be received by the respective shareholders in the Exchanges assuming no shareholder in either Exchange elects to take the cash alternatives being offered under the respective proposals and (b) the total cash that could be received by the respective shareholders in the Exchanges assuming the shareholders in the Exchanges elect to take the maximum level of cash available under the cash alternatives being offered under the respective proposals.

It should be noted, however, that the aggregate number of HKEC Shares owned by Stock Exchange Shareholders in proportion to the aggregate number of HKEC Shares owned by Futures Exchange Shareholders may differ from what is outlined above depending on the extent to which shareholders in the respective Exchanges elect to take the cash alternatives being offered under the respective proposals. Assuming that no Stock Exchange Shareholders make an election to take the Stock Exchange Cash Alternative, but that Futures Exchange Shareholders elect to receive cash up to the Futures Exchange Cash Limit then, immediately following completion of the Overall Proposal, Stock Exchange Shareholders will hold approximately 77 per cent. in aggregate of the issued HKEC Shares. Conversely, if Stock Exchange Shareholders make elections to take the Stock Exchange Cash Alternative up to the Stock Exchange Cash Limit, but no Futures Exchange Shareholders elect to take the Futures Exchange Cash Alternative then, immediately following completion of the Overall Proposal, Stock Exchange Shareholders will hold approximately 61 per cent. in aggregate of the issued HKEC Shares.

ISSUED SHARE CAPITAL OF HKEC

If no elections to take the Stock Exchange Cash Alternative are made by Stock Exchange Shareholders, and if no elections to take the Futures Exchange Cash Alternative are made by the Futures Exchange Shareholders, HKEC will have approximately 1,068.4 million issued HKEC Shares immediately following completion of the Overall Proposal. If Stock Exchange Shareholders make elections to take the Stock Exchange Cash Alternative up to the Stock Exchange Cash Limit and Futures Exchange Shareholders make elections to take the Futures Exchange Cash Alternative up to the Futures Exchange Cash Limit, HKEC will have approximately 724.0 million issued HKEC Shares immediately following completion of the Overall Proposal.

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TRANSFERS AND LISTING OF HKEC SHARES

As set out in the Letter from HKEC, the HKEC Shares will be freely transferable from the time they are issued. It is proposed that no person (other than a person who falls within one of the categories of permitted persons) will be permitted to have an interest in more than 5 per cent. of the votes that could be cast on any resolution at any general meeting of HKEC. The attention of Stock Exchange Shareholders is drawn to the paragraph headed "Shareholding limit" in the section of the Letter from HKEC headed "Description of HKEC and the HKEC Group" on pages 39 to 46 of this document. HKEC intends to obtain a listing for the HKEC Shares as soon as practicable and hopefully by 30th September, 2000.

TRADING RIGHTS

With effect from the Effective Date, ownership of shares in the Stock Exchange and access to its trading facilities will be separated. Further details regarding trading rights are set out in the section of the Letter from HKEC headed "Relevant Material Aspects of the Market Reforms" on pages 35 to 39 of this document.

CHANGES IN CIRCUMSTANCES

Stock Exchange Shareholders will vote on the Stock Exchange Proposal on the basis of the information contained in this document. The attention of Stock Exchange Shareholders is, however, drawn to the fact that much of the information contained in the Letter from HKEC, in appendix VI to this document entitled "Summary of the Enabling Legislation" and in appendix VII to this document entitled "Summary of relevant provisions in the Composite Bill" is in the form of proposals only (except for the avoidance of doubt, the provisions relating to Trading Rights set out in paragraphs (a) to (d) under the heading "Relevant Material Aspects of the Market Reforms" in the Letter from HKEC) which are subject to modification or amendment. The attention of Stock Exchange Shareholders is also drawn to the fact that upon satisfaction of the Conditions set out in paragraphs (a) to (d) under the heading "Conditions of the Stock Exchange Proposal" in this Explanatory Statement, the Council will, at the time the board of the Futures Exchange does the same in respect of the Futures Exchange Scheme, deliver to the Registrar of Companies in Hong Kong for registration an office copy of the order of the Court in respect of the Stock Exchange Scheme, together with the minute containing the particulars required by section 61 of the Companies Ordinance, and that the Stock Exchange Scheme will become effective notwithstanding any event, series of events or circumstances concerning or relating to or otherwise having an adverse effect on, or any change in, local, national or international financial, political, economic, legal, fiscal, regulatory or market matters or conditions.

HONG KONG TAX CONSIDERATIONS

The following paragraphs, which are intended as a general guide only, are based on current legislation and Inland Revenue Department practice. They summarise certain limited aspects of the Hong Kong taxation treatment of the Stock Exchange Proposal. If you are in any doubt as to your taxation position or if you are subject to taxation in any jurisdiction other than Hong Kong, you should consult an appropriate professional adviser immediately.

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(a) Hong Kong Profits Tax

The receipt, by a Stock Exchange Shareholder who holds his Stock Exchange Shares as a capital asset, of Cancellation Consideration resulting from the cancellation of his Stock Exchange Shares should not be regarded as a taxable receipt from his business, and should not be subject to profits tax under section 14 of the Inland Revenue Ordinance (Chapter 112 of the Laws of Hong Kong).

(b) Stamp Duty

No stamp duty will be payable by Stock Exchange Shareholders as a result of the cancellation of their Stock Exchange Shares and receipt of HKEC Shares and/or cash pursuant to the Stock Exchange Scheme.

MEETINGS AND ACTION TO BE TAKEN BY STOCK EXCHANGE SHAREHOLDERS

Meetings

In accordance with the direction of the Court, the Court Meeting has been convened for the purpose of considering and, if thought fit, passing a resolution to approve the Stock Exchange Scheme.

The Extraordinary General Meeting has been convened to be held immediately following the Court Meeting for the purpose of considering and, if thought fit, passing the following resolutions:

1. A special resolution to approve:
 - (i) the reduction on the Effective Date of the share capital of the Stock Exchange by cancelling the Stock Exchange Scheme Shares; and
 - (ii) subject to and forthwith upon such reduction of capital taking effect the increase of the authorised share capital of the Stock Exchange to its former amount by *the creation of such number of new Stock Exchange Shares as is equal to the number of Stock Exchange Scheme Shares cancelled*; and
 - (iii) the application of the credit which will arise in its books of account as a result of the cancellation of the Stock Exchange Scheme Shares to allot and issue in aggregate the same number of new Stock Exchange Shares credited as fully paid to HKEC and its nominee.
2. A special resolution, subject to the approval of the SFC, to amend the Articles of Association of the Stock Exchange in order to dispense with the requirement to carry out the election process for the Council at the 1999 Annual General Meeting of the Stock Exchange and to enable all members of the Council and the Nominating Committee and the Chairman and Vice Chairmen to remain in office pending the Stock Exchange Scheme taking effect.
3. A special resolution, subject to the approval of the SFC, to amend the objects clause in the Memorandum of Association of the Stock Exchange to give the Council wider powers.

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4. A special resolution, subject to the approval of the SFC, to amend the objects clause in the Memorandum of Association of the Stock Exchange, to be effective upon the Stock Exchange becoming a wholly owned subsidiary of HKEC, to enable the Stock Exchange to pay dividends to its shareholders, and to make consequential amendments such as substituting references to exchange participants for references to members.
5. A special resolution, subject to the approval of the SFC, to adopt a new set of Articles of Association of the Stock Exchange, to be effective upon the Stock Exchange becoming a wholly owned subsidiary of HKEC.

The Meetings will be held at 1st Floor, One and Two Exchange Square, Central, Hong Kong on Monday, 27th September, 1999. The Court Meeting has been convened for 4:30 p.m. on that date and the Extraordinary General Meeting has been convened for the same date at 4:45 p.m., or as soon thereafter as the Court Meeting has been concluded or adjourned.

Notices of the Meetings are set out on pages 200 to 206 of this document.

Action to be taken by Stock Exchange Shareholders

You will find enclosed a pink form of proxy for use at the Court Meeting and a white form of proxy for use at the Extraordinary General Meeting.

Whether or not you are able to attend the Meetings in person, you are strongly urged to complete and sign the enclosed pink form of proxy and white form of proxy in accordance with the instructions printed thereon and to lodge them, at the registered office of the Stock Exchange, 1st Floor, One and Two Exchange Square, Central, Hong Kong, as soon as possible but in any case not later than the respective following times.

In order to be valid, the pink form of proxy for the Court Meeting should be lodged not later than 4:30 p.m. on 25th September, 1999 or may alternatively be handed to the Chairman of that Meeting at the Meeting.

In order to be valid, the white form of proxy for the Extraordinary General Meeting should be lodged not later than 4:45 p.m. on 25th September, 1999.

A proxy may only vote on a poll and not on a show of hands. A proxy must produce upon request at the Meeting his Hong Kong Identity Card or passport for identification purpose once a poll is taken. The completion and return of a form of proxy for the Court Meeting or the Extraordinary General Meeting will not preclude you from attending the relevant Meeting and voting in person. In that event, your form of proxy for the relevant Meeting will be deemed to have been revoked.

A body corporate which is a Stock Exchange Shareholder may by resolution of its directors or other governing body authorise such person as it thinks fit to act as its representative at any of the Meetings. A corporate representative is entitled to vote on a show of hands and on a poll.

Additional copies of the forms of proxy can be obtained from the registered office of the Stock Exchange, 1st Floor, One and Two Exchange Square, Central, Hong Kong during usual business hours on any business day up to 5:30 p.m. on 24th September, 1999.

EXPLANATORY STATEMENT

Subject as set out immediately below, those persons who are registered as Stock Exchange Shareholders on the Stock Exchange's share register at the time the Meetings are held will be entitled to vote at the Meetings. At the Extraordinary General Meeting, in accordance with the Articles of Association of the Stock Exchange, the voting rights attaching to a Stock Exchange Share are not eligible to be exercised in any of the following circumstances:

- 1 if any moneys due from the Stock Exchange Shareholder are more than one month in arrears;
- 2 if the Stock Exchange Shareholder has died, become insane or of unsound mind, or has become bankrupt or, in the case of a corporation, has passed a resolution to wind up, or a court order for the appointment of a provisional liquidator or for winding up has been made against such corporation; or
- 3 if the Council or the Disciplinary Committee of the Council has resolved to suspend the membership of the Stock Exchange Shareholder.

Such restrictions will not apply to the eligibility of a Stock Exchange Shareholder to exercise voting rights at the Court Meeting. Voting rights at the Court Meeting may be exercised in person or by proxy or, in the case of a person claiming to exercise voting rights as the lawful representative of a Stock Exchange Shareholder, by such lawful representative acting in person or by proxy subject to production at the Court Meeting of evidence to the satisfaction of the Chairman thereof of the capacity in which and the authority by which the person claiming to act as the Stock Exchange Shareholder's lawful representative is entitled so to act.

Transfer Approval Deadline

In order to receive the Cancellation Consideration under the Stock Exchange Scheme it will be necessary to be registered as a Stock Exchange Shareholder immediately prior to the Effective Date. For any transfer of Stock Exchange Shares to be registered it is necessary, among other things, for the admission of the transferee to be approved by the Council in accordance with the Articles of Association of the Stock Exchange. The latest time at which such approval may be given will be the last meeting of the Council before the Effective Date held for such purpose. The date of such meeting of the Council (being the Transfer Approval Deadline) will be notified to Stock Exchange Shareholders by the Stock Exchange in writing at least 14 days in advance, and will also be announced in the Newspapers, and will be not less than 14 days before the Effective Date. Transferors and transferees of Stock Exchange Shares should ensure that all requirements for admission of the transferees as Stock Exchange Shareholders shall have been met before the Transfer Approval Deadline so that their applications for admission will be considered by the Council at that meeting.

Choice of Consideration under the Scheme - Forms of Election

Unless a Stock Exchange Shareholder makes an election to receive the Stock Exchange Cash Alternative he will receive HKEC Shares by way of the Cancellation Consideration.

A Stock Exchange Shareholder may receive all the Cancellation Consideration in the form of HKEC Shares, or make an election to receive the Stock Exchange Cash Alternative in respect of all or some only of the HKEC Shares to which the Stock Exchange Shareholder becomes entitled.

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Elections may only be made on the Forms of Election which are being sent to Stock Exchange Shareholders together with this document. To be valid, Forms of Election must be completed in full in accordance with the instructions on them and lodged at the registered office of the Stock Exchange, 1st Floor, One and Two Exchange Square, Central, Hong Kong no later than 5:30 p.m. on the Election Deadline. Any Form of Election which is received after this time and date, or is received before this time and date but which has been completed incorrectly shall be treated as invalid and the relevant Stock Exchange Shareholder purporting to make the election shall not be entitled to receive any cash under the Stock Exchange Cash Alternative. Once made, elections shall be irrevocable. HKEC however reserves the right to treat a Form of Election which has been completed incorrectly in some manner which (at its absolute discretion) is not material as being valid.

Additional copies of the Forms of Election may be obtained from the registered office of the Stock Exchange, 1st Floor, One and Two Exchange Square, Central, Hong Kong during usual business hours on any business day up to 5:00 p.m. on the Election Deadline.

SETTLEMENT

Upon the Stock Exchange Scheme becoming effective the Cancellation Consideration will become payable. The Cancellation Consideration will be paid to each Stock Exchange Shareholder whose name appears immediately prior to the Effective Date on the register of members of the Stock Exchange. Certificates representing the HKEC Shares and/or cheques for the requisite cash amount will be despatched to Stock Exchange Shareholders within 10 days of the Effective Date. Additionally, letters will be despatched to Stock Exchange Shareholders who make valid elections for the Stock Exchange Cash Alternative, confirming the basis of calculation of their entitlements to receive cash.

Certificates for HKEC Shares and/or cheques will be sent by HKEC to Stock Exchange Shareholders at their respective registered addresses. All such certificates and/or cheques will be sent at the risk of the persons entitled to them and neither the Stock Exchange nor HKEC will be responsible for any loss or delay in transmission.

SHARE CERTIFICATES

Upon the Stock Exchange Scheme becoming effective all the Stock Exchange Scheme Shares will be cancelled and all the certificates representing Stock Exchange Scheme Shares will accordingly cease to have effect as documents or evidence of title.

EXPENSES OF THE STOCK EXCHANGE SCHEME

It is estimated that the costs, charges and expenses of and incidental to the Stock Exchange Scheme and the costs of carrying the same into effect to be borne by the Stock Exchange will amount to approximately HK\$20 million. HKEC shall bear its own costs, charges and expenses in connection with the Stock Exchange Scheme.

FURTHER INFORMATION

Further information relating to the Stock Exchange Proposal is set out in the appendices to this document and the Letter from HKEC. In particular, appendices II and VIII to this document ("Financial and other information relating to the Stock Exchange Group" and "General information", respectively) form part of this Explanatory Statement. The general information in appendix VIII to this document includes information on interests of the Council Members in relation to the Stock Exchange Proposal.

1. FINANCIAL STATEMENTS OF HKEC

HKEC was incorporated as a private company with limited liability in Hong Kong on 8th July, 1999 under the Companies Ordinance for the purpose of acting as the holding company of the Exchanges and HKSCC. HKEC has not carried on any business since the date of its incorporation other than entering into agreements in respect of the financing of the Stock Exchange Cash Alternative and the Futures Exchange Cash Alternative.

No audited financial statements have been prepared for HKEC since the date of its incorporation.

2. PRO FORMA COMBINED FINANCIAL INFORMATION OF HKEC FOR THE YEAR ENDED 30TH JUNE, 1999

Set out below are the pro forma combined statement of operations of HKEC for the year ended 30th June, 1999 and its pro forma combined statement of net assets as at the same date and the notes thereon ("pro forma financial information"). The pro forma financial information has been compiled from the consolidated audited financial statements of the Exchanges and HKSCC made up to 30th June, 1999 as set out in appendices II to IV to this document, which have not been independently verified by HKEC or its advisors. Certain balances have been re-classified based on information received by HKEC. All material inter-company transactions have been eliminated on combination. The objective of preparing this pro forma financial information is to show the operating results and net assets of HKEC had the Overall Proposal as described in page 30 of the Letter from HKEC taken effect on 1st July, 1998 and all other circumstances remained as they were.

The pro forma financial information set out below is for illustrative purposes only and is not necessarily indicative of the operating results that would have been achieved by HKEC for the year ended 30th June, 1999 and the net assets that would have been attributable to HKEC at that date had the Overall Proposal taken effect on 1st July, 1998.

(a) Pro forma combined statement of operations of HKEC for the year ended 30th June, 1999

	<i>Note</i>	<i>HK\$'000</i>
Total revenue	2	2,069,000
Operating expenses	3	<u>(1,505,299)</u>
Surplus before taxation		563,701
Taxation	4	<u>(24,843)</u>
Surplus for the year		<u><u>538,858</u></u>

(b) Pro forma combined statement of net assets of HKEC at 30th June, 1999

	<i>Note</i>	<i>HK\$'000</i>
Reserve fund net assets of the		
Futures Exchange Group	5	388,272
Guarantee Fund of the HKSCC Group	6	200,000
Fixed assets	7	583,149
Rental, utility and other deposits		8,249
Current assets	8	12,476,845
Current liabilities	9	(9,347,932)
Net current assets		<u>3,128,913</u>
Total assets less current liabilities		4,308,583
Deferred taxation	10	(46,631)
Liabilities of the HKSCC Group for participants' admission fees	11	<u>(108,900)</u>
Net assets		<u><u>4,153,052</u></u>

*Notes:***1 Principal accounting policies**

Consistent with the bases and objectives of preparing this pro forma financial information as noted above, the principal accounting policies set out below have been extracted or summarised from the audited financial statements of the Stock Exchange Group, the Futures Exchange Group and the HKSCC Group, and may not necessarily be adopted by HKEC should the Overall Proposal become effective.

The financial statements of the Stock Exchange Group, the Futures Exchange Group and the HKSCC Group have been prepared in accordance with accounting principles generally accepted in Hong Kong. A summary of the principal accounting policies is set out below.

(a) Recognition of income**(i) The Stock Exchange Group**

Revenue is recognised when it is probable that the economic benefits will flow to the Stock Exchange Group and when the revenue can be measured reliably, on the following bases:

- Transaction levy and trading tariff, on a trade date basis;
- Income from members, listed companies and customers, on the rendering of services;
- Stock information income, on the rendering of services;
- Interest income, on a time apportioned basis taking into account the principal outstanding and the interest rates applicable; and
- Rental income, on a time apportioned basis.

(ii) *The Futures Exchange Group*

Interest income is recognised on a time apportioned basis, taking into account the principal outstanding and interest rates applicable.

Revenue in respect of services rendered is recognised upon completion.

(iii) *The HKSCC Group*

Fees for clearing and settlement of broker-to-broker trades in eligible securities transacted on the Stock Exchange are recognised in full on T+1, i.e. on the settlement day following the trade day, upon acceptance of the trades by HKSCC. Fees for settlement of other trades and transactions are recognised upon completion of the settlement. Custody fees for securities held in the CCASS depository are calculated and accrued on a monthly basis. Surpluses on registration and transfer fees on nominee services are calculated and accrued on the book close dates of the relevant stocks during the financial year. Other fees are recognised when HKSCC renders the related services.

Service fees are stated in the statement of operations net of fee discounts which are granted by HKSCC from time to time.

Interest income is recognised on a time apportioned basis based on the principal amounts outstanding at the applicable rates of interest.

(b) **Recognition of receivables and payables from/to broker participants on Stock Exchange trades settled on the Continuous Net Settlement ("CNS") basis**

The HKSCC Group

Upon acceptance of Stock Exchange trades for settlement in CCASS under CNS on a T+2 basis, HKSCC interposes itself between the broker participants as the settlement counterparty to the trades through novation. Final acceptance of such Stock Exchange trades is confirmed on T+1 by details contained in the final clearing statement transmitted by HKSCC to every broker participant.

The CNS money obligations due by/to broker participants on Stock Exchange trades which are confirmed and accepted on T+1 are thereafter recognised as receivables and payables on the balance sheets made up to such date and such later dates on which the said receivables and payables remain outstanding.

Money obligations relating to all other trades and transactions, for which HKSCC is merely providing a facility for their settlement within CCASS, are excluded from the financial statements of the HKSCC Group.

(c) **Fixed assets**

(i) *Investment property*

Investment property of the Stock Exchange Group is interest in a property in respect of which construction work and development have been completed and which is intended to be held on a long term basis for its investment potential. Such property is not depreciated and is stated at its open market value on the basis of a professional valuation performed at the end of each financial year. Changes in the value of the investment property are dealt with as movements in the investment property revaluation reserve. If the total of this reserve is insufficient to cover a deficit, on a portfolio basis, the excess of the deficit is charged to the statement of operations.

On disposal of an investment property, the relevant portion of the investment property revaluation reserve realised in respect of previous valuations is released to the statement of operations.

(ii) *Other fixed assets*

Fixed assets, other than the investment property, are stated at cost or valuation (applicable to the Stock Exchange Group only) less depreciation calculated to write off the cost or valuation of the assets on a straight line basis over the following anticipated useful lives:

	The Stock Exchange Group	The Futures Exchange Group	The HKSCC Group
Land held under long-term leases	Unexpired lease term	N/A	N/A
Buildings	4%	N/A	N/A
Leasehold improvements	20%	Unexpired lease term	The shorter of the period of the lease and the expected useful life
Mainframe, computer trading system and personal computer hardware and other software	14.3% to 33.33%	33.33% to 50%	33.33%
Application software and development expenditure on completed projects	N/A	N/A	20%
Furniture and office equipment	20%	33.33%	20%
Motor vehicles	33.33%	33.33%	25%
Air-conditioning systems	N/A	Unexpired lease term	N/A

The cost of an asset comprises its purchase price and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Expenditure incurred after the fixed assets have been put into operation, such as repairs and maintenance, is normally charged to the statement of operations in the period in which it is incurred. In situations where it can be clearly demonstrated that the expenditure has resulted in an increase in the future economic benefits expected to be obtained from the use of the fixed asset, the expenditure is capitalised as an additional cost of the fixed asset.

When assets are sold or retired, their cost and accumulated depreciation are eliminated from the accounts and any gain or loss resulting from their disposal, being the difference between the sales proceeds and the carrying amount of the relevant asset, is included in the statement of operations. Any related revaluation surpluses are transferred from fixed assets revaluation reserve to retained surplus.

(iii) *Development expenditure*

The Stock Exchange Group

Project development expenditure incurred on specific projects is carried forward when its recoverability can be foreseen with reasonable assurance. On completion of the projects, this expenditure will be either capitalised as fixed assets and depreciated in accordance with the above stated depreciation policy or charged to the statement of operations.

The HKSCC Group

Development expenditure capitalised and recognised as a fixed asset comprises all direct and allocated operating expenses attributable to development activities of distinct major projects approved by the board and which satisfy the following criteria:

- (i) the project is technically and financially feasible for completion and use by the HKSCC Group; and

- (ii) there is a demonstrated external demand for the services and facilities provided by the application of the completed project and its estimated future economic benefits or revenues would not be less than the carrying value of the development expenditure included under fixed assets.

All operating and maintenance expenses incurred after the date of completion of the above projects as well as all expenses incurred on other non-qualifying projects and development activities are charged as expenses to the statement of operations in the period in which such expenses are incurred.

Amortisation of the cost of capitalised development expenditure is provided from the dates when the projects become operational.

(d) Investments

(i) The Stock Exchange Group

Investments, which are unlisted, are stated at cost less provision for any permanent diminution in value. Income from investments is accounted for to the extent of interest received or receivable.

(ii) The Futures Exchange Group

Investment securities are comprised of investment grade debt securities and an investment in a professionally managed money market fund. The debt securities and money market fund investment are readily convertible into cash and are carried in the balance sheet as current assets. The liquidity of the investment securities is designed to mirror the Futures Exchange Clearing Members' margin deposits.

The investment securities, which are unlisted, are stated at cost less provision for any permanent diminution in value, on the basis that they are clearly identifiable and are intended by the directors to be held on a continuing basis.

Profits or losses on realisation of investment securities are accounted for in the statement of operations as they arise and are included in gains on disposal of investment securities. Interest arising from investment securities is recognised in accordance with accounting policy (a)(ii) above.

(e) Operating leases

Leases where substantially all the rewards and risks of ownership of assets remain with the leasing company are accounted for as operating leases. Rentals applicable to such operating leases are charged to the statement of operations on a straight line basis over the lease term, except for rentals capitalised under development expenditure, which are accounted for in accordance with accounting policy (c)(iii) above.

(f) Deferred taxation

Deferred taxation is calculated under the liability method in respect of the taxation effect arising from all timing differences which are expected with reasonable probability to crystallise in the foreseeable future.

(g) Translation of foreign currencies

Foreign currency transactions during the year are translated into Hong Kong dollars at the exchange rates ruling on the transaction dates. Foreign currency balances of monetary assets and liabilities at 30th June, 1999 are translated into Hong Kong dollars at the exchange rates ruling at such date; foreign currency balances of non-monetary assets and liabilities are translated at historical rates. Exchange gains and losses are dealt with in the statement of operations.

(h) **Guarantee Fund***The HKSCC Group*

Under CCASS General Rule 2501, a fund has been established by way of contributions in cash and otherwise from broker participants ("Guarantee Fund"). The HKSCC has also made cash contributions to the Guarantee Fund for the purpose of providing additional resources to the Guarantee Fund. The financial statements of the HKSCC Group do not include the results, assets and liabilities of the Guarantee Fund, for which separate financial statements have been prepared.

2 Total revenue

	<i>HK\$'000</i>
Transaction levy, clearing and settlement fees	525,157
Interest income	784,497
Stock information income	209,527
Listing fees	196,721
Depository and nominee services fees	173,231
Membership fees	116,204
Other revenues, including rental income	<u>63,663</u>
	<u>2,069,000</u>

3 Operating expenses

	<i>HK\$'000</i>
Staff costs and related expenses	542,450
Interest paid to members of HKFECC which are entitled in accordance with the rules and procedures of HKFECC to register and clear with HKFECC futures and options contracts traded on the Futures Exchange ("Futures Exchange Clearing Members")	296,894
Depreciation, amortisation and loss on disposal of fixed assets	160,190
Maintenance and network expenses	166,987
Rent and rates	114,528
Administrative and other expenses	<u>224,250</u>
	<u>1,505,299</u>

4 Taxation

The taxation charge in the pro forma combined statement of operations represents:

	<i>HK\$'000</i>
Provision for Hong Kong profits tax for the year	40,227
<i>Overprovision of Hong Kong profits tax in prior years</i>	<i>(8,238)</i>
Transfer from deferred taxation	5,576
10% refund of profits tax in respect of the prior year	<i>(12,770)</i>
Others	<u>48</u>
	<u><u>24,843</u></u>

Hong Kong profits tax has been provided at the rate of 16% on the estimated assessable profits for the year.

5 Reserve fund net assets of the Futures Exchange Group

The investments included in the reserve fund are composed of debt securities and short term deposits and comprise:

	<i>HK\$'000</i>
Debt securities	396,516
Short term deposits	<u>8,721</u>
	405,237
Less: net amounts payable	<u>(16,965)</u>
	<u><u>388,272</u></u>

The debt securities are comprised of investment grade paper with a Moody's credit rating of single A or higher and can be converted into cash within one trading day.

6 Guarantee Fund of the HKSCC Group

HKSCC has contributed a cumulative total of \$200 million at 30th June, 1999 in cash to provide additional resources to the Guarantee Fund. The contribution is administered by the Risk Management Committee of HKSCC. Contributions will be recoverable by HKSCC when the Risk Management Committee considers that they are in excess of the total resources required by the Guarantee Fund. In accordance with the Terms of Reference of the Risk Management Committee laid down by the board of directors of HKSCC, the Risk Management Committee exercises all the powers and functions of the board of directors on all matters concerning risk management under CCASS including the administration of the Guarantee Fund and the investment of the Guarantee Fund's assets, according to the rules and policies laid down by the board of directors.

7 Fixed assets

	Cost or valuation HK\$'000	Accumulated depreciation HK\$'000	Net book value HK\$'000
Investment property	16,400	—	16,400
Land and buildings	235,096	(18,380)	216,716
Leasehold improvements, furniture and equipment, air conditioning system and motor vehicles	307,010	(237,485)	69,525
Computer trading systems, hardware and software	730,984	(475,045)	255,939
Application software and development expenditure	<u>353,483</u>	<u>(328,914)</u>	<u>24,569</u>
	<u>1,642,973</u>	<u>(1,059,824)</u>	<u>583,149</u>

8 Current assets

		HK\$'000
Accounts receivable		135,942
CNS money obligations of the HKSCC Group		2,506,829
CCASS fees		5,319
Shares bought-in and borrowed for CNS settlement	8.1	18,798
Investments	8.2	951,250
Deposits and prepayments		53,701
Futures Exchange Clearing Members' margin fund	8.3	5,417,934
Options clearing members' margin fund of the Stock Exchange Group	8.4	619,984
Profits tax recoverable	8.5	11,844
SFC's share of transaction levy receivable		13,471
Stamp duty receivable		54,757
Cash held for payment of stamp duty		33,448
Temporary receipts assets	8.6	82,138
Time deposits with banks		2,449,575
Cash at bank and in hand		<u>121,855</u>
		<u>12,476,845</u>

8.1	<i>Shares bought-in and borrowed for CNS settlement</i>	<i>HK\$'000</i>
	Shares on hand at cost, representing buy-ins on T+3 by the Stock Exchange against unsettled CNS short positions. Shares were on hold for delivery to the short brokers pending confirmation of good payment by them on 2nd July, 1999	13,750
	Shares at market value due and receivable from CNS short positions which in the meantime had been borrowed by the Stock Exchange for delivery to CNS long positions	<u>5,048</u>
		<u>18,798</u>
8.2	<i>Investments</i>	<i>HK\$'000</i>
	<u>The Futures Exchange Group</u>	
	Professionally managed debt securities portfolio	872,910
	Debt securities	58,434
	<u>The Stock Exchange Group</u>	
	Fixed rate instruments denominated in HK\$	<u>19,906</u>
		<u>951,250</u>
8.3	<i>Futures Exchange Clearing Members' margin fund</i>	<i>HK\$'000</i>
	Money market fund	792,209
	Debt securities	3,068,247
	Bank deposits	<u>1,557,478</u>
		<u>5,417,934</u>
8.4	<i>Options clearing members' margin fund of the Stock Exchange Group</i>	<i>HK\$'000</i>
	Bank deposits	
	— call and time deposits (maturing in less than 3 months)	329,688
	— bank current accounts	917
	Listed securities held	210,835
	Receivables	<u>78,544</u>
		<u>619,984</u>

8.5 *Profits tax recoverable/(payable)*

	<i>HK\$'000</i>
Profits tax recoverable of the Futures Exchange Group	
Provision for Hong Kong profits tax for the year	(8,763)
Payment of provisional profits tax for the year	27,456
Other Hong Kong taxation payable	(41)
Tax payable relating to prior years	<u>(6,808)</u>
Profits tax recoverable	<u>11,844</u>
	<i>HK\$'000</i>
Profits tax payable of the Stock Exchange and HKSCC Groups	
Provision for Hong Kong profits tax for the year	(31,464)
Tax payable relating to prior years	<u>(930)</u>
Profits tax payable	<u>(32,394)</u>

8.6 *Temporary receipts assets*

Temporary receipts assets represent deposits at banks held by the Stock Exchange Group on behalf of Stock Exchange Shareholders, deposits from Stock Exchange Shareholders relating to options trading, tenants' deposits and stamp duty deposits. These are ultimately refundable and the corresponding liabilities are included in current liabilities.

9 Current liabilities

		<i>HK\$'000</i>
Accounts payable		115,399
CNS money obligations of the HKSCC Group		2,513,278
Marks collected		84,502
Cash margins received		8,353
Deposits received on investor accounts refundable 3 months after closing of account		2,217
Collateral received on shares bought-in and value of shares due to lenders	9.1	18,911
Other payables and accruals		105,183
Profits tax payable	8.5	32,394
Deferred revenue of the Stock Exchange Group	9.2	93,230
Futures Exchange Clearing Members' margin deposits	9.3	5,417,934
Options clearing members' margin deposits of the Stock Exchange Group	9.4	619,984
Payable to Unified Exchange Compensation Fund	9.5	150,000
SFC's share of transaction levy payable		15,053
Stamp duty payable		88,205
Temporary receipts refundable	8.6	82,138
Amount payable to reserve fund of the Futures Exchange Group		<u>1,151</u>
		<u><u>9,347,932</u></u>

9.1 Collateral received on shares bought-in and value of shares due to lenders

		<i>HK\$'000</i>
Payments by short brokers for buy-in shares executed by HKSCC in respect of:		
— shares on-hold by HKSCC		13,750
— shares pending receipt by HKSCC		113
Shares at market value due to lenders pending delivery of shares receivable from CNS short positions by HKSCC		<u>5,048</u>
		<u><u>18,911</u></u>

9.2 Deferred revenue of the Stock Exchange Group

Deferred revenue of the Stock Exchange Group comprises annual listing fees received in advance, payments received for undelivered services in relation to the sales of stock market information and telecommunication line rental for the second and third terminals.

9.3 *Futures Exchange Clearing Members' margin deposits*

These amounts represent the net balances due to Futures Exchange Clearing Members at 30th June, 1999 in respect of open contracts which will not crystallise until the settlement date. Any potential losses in respect of open contracts may be set off against Futures Exchange Clearing Members' margin deposits, bank guarantees or potential profit on other contracts.

In addition to the deposits, certain Futures Exchange Clearing Members have given bank guarantees in connection with temporary adjustments of their trading limits.

9.4 *Options clearing members' margin deposits of the Stock Exchange Group*

These represent the net balances due to options clearing members at 30th June, 1999 in respect of premium, stock settlement amounts, margin required on uncovered open short options contracts and pending stock positions arising from the exercise and assignment of options contracts, and shares of underlying stocks deposited for collateral purposes.

9.5 *Payable to Unified Exchange Compensation Fund*

As a result of the turmoil in the Asian markets in late 1997, and the subsequent failure of certain institutions connected with the securities markets, the Government, the SFC and the Stock Exchange announced on 26th January, 1998 that they would review the statutory limit of the Unified Exchange Compensation Fund ("Fund") in the case of CA Pacific Securities Limited and that the SFC and the Stock Exchange would make a contribution to the Fund as soon as on-going action to put the SFC into a position to make this contribution was complete. In this connection during the year ended 30th June, 1998, the Stock Exchange resolved to inject HK\$150 million into the Fund to meet additional compensation to be payable to certain public investors.

10 **Deferred taxation**

This mainly represents the tax effect of accelerated tax depreciation allowances on fixed assets.

There was no significant deferred tax liability not provided for at 30th June, 1999.

11 **Liabilities of the HKSCC Group for participants' admission fees**

CCASS General Rule 303 provides that every CCASS participant other than an investor participant shall pay an admission fee and sign a participant agreement with HKSCC. The purpose of the admission fee is to finance the development costs of CCASS and to reduce the loan interest burden of HKSCC, the effect of which has been taken into account in determining the CCASS tariff structure. HKSCC has prescribed that the admission fee for broker participants is HK\$50,000 for every 'A' Stock Exchange Share held by the participant in the Stock Exchange; the admission fee for custodian and clearing agency participants is HK\$1,000,000 each; and for stock pledgee participants, the fee is HK\$200,000 each. The admission fees are non-interest bearing and may be repayable upon the expiry of seven years from the date of admission of the participant or upon the termination of the participant's participation in CCASS, whichever is later. HKSCC at its discretion has granted early refunds of admission fees to terminated participants after six months from the date of termination of their participation in CCASS and to broker participants after six months from the date of sale of their Stock Exchange Shares.

12 Reserves

The following is a summary of the reserves maintained by the Stock Exchange Group, the Futures Exchange Group and the HKSCC Group at 30th June, 1999, which do not necessarily represent the type and amount of reserves that will be maintained by HKEC should the Overall Proposal become effective:

		<i>HK\$'000</i>
Retained surplus	12.1	1,897,853
Revaluation reserve of the Stock Exchange Group	12.2	113,597
General reserve of the HKSCC Group	12.3	380,000
Risk management reserves	12.4	688,272
General reserve - property of the Stock Exchange Group	12.5	250,000
Reserve for capital infrastructure of the HKSCC Group	12.6	450,000
Development reserve of the Stock Exchange Group	12.7	207,808
Reserve for projects and development of the HKSCC Group	12.8	100,000
Development fund of the Futures Exchange Group	12.9	<u>36,761</u>
		<u>4,124,291</u>

12.1 *Retained surplus*

This represents the retained surplus after transfers to reserves/funds.

12.2 *Revaluation reserve of the Stock Exchange Group*

	<i>HK\$'000</i>
Property revaluation reserve (property for own use)	105,426
Investment property revaluation reserve	<u>8,171</u>
Total	<u>113,597</u>

12.3 *General reserve of the HKSCC Group*

This represents the retained surplus set aside by HKSCC and available for making good any future temporary operating deficit in the statement of operations as a result of shrinkage in stock market turnover before having to revert to an increase in CCASS tariffs and for other contingencies.

12.4 *Risk management reserves*

These include two reserves as follows:

		<i>HK\$'000</i>
Reserve fund of HKFECC, a subsidiary of the Futures Exchange	(a)	388,272
Reserve for guarantee fund and risk management of the HKSCC Group	(b)	<u>300,000</u>
		<u>688,272</u>

- (a) The reserve fund was established to enable HKFECC to discharge its functions and is required to have, at all times, aggregate available funds of not less than HK\$200 million. It is principally contributed by Futures Exchange Clearing Members.

The reserve fund at 30th June, 1999 is comprised of the following:

	<i>HK\$'000</i>
Futures Exchange Clearing Members' deposits	210,000
Interest income credited to the reserve fund	70,541
Former clearing house funds	
Appropriation from reserves of HKFECC	77,408
Accrued interest	11,125
Appropriation from reserves of HKFECC	<u>20,200</u>
	389,274
Less: Insurance premiums	(752)
Bank guarantee fees	<u>(250)</u>
	<u>388,272</u>
Insurance policies	120,000
Bank guarantees	50,000

Both insurance policies and bank guarantees are renewed annually on 1st January. Commencing on 1st January, 1999, insurance premiums and bank guarantees fees have been borne by the reserve fund.

In the event of a claim against HKFECC which requires recourse to the reserve fund, the order of application of resources is as follows:

First	Appropriation from reserves of HKFECC
Second	Interest income credited to the reserve fund
Third	Futures Exchange Clearing Members' deposits
Fourth	Insurance policies
Fifth	Former clearing house funds
Sixth	Bank guarantees and facilities

- (b) This is retained surplus set aside by HKSCC for providing additional resources to the Guarantee Fund and for general risk management purposes in support of CCASS and depository operations.

12.5 *General reserve - property of the Stock Exchange Group*

This was appropriated from the retained surplus of the Stock Exchange for the purpose of acquiring office premises in the future.

12.6 *Reserve for capital infrastructure of the HKSCC Group*

This represents the amount of retained surplus set aside by HKSCC for investment in fixed assets other than projects under development.

12.7 *Development reserve of the Stock Exchange Group*

This includes transaction levy received in excess of one-third of the Stock Exchange's budgeted recurrent expenses which has been appropriated to the development reserve in accordance with the budgetary guidelines approved by the Financial Secretary in May 1996.

The Stock Exchange has also transferred to the development reserve one-seventh of its share of income from transaction levy (representing 9.09% of the total transaction levy received), less any applicable profits tax, since 1st April, 1998 in accordance with a new budgetary guideline provided by the Financial Secretary of Hong Kong in April 1998.

12.8 *Reserve for projects and development of the HKSCC Group*

This represents the amount of retained surplus set aside in respect of any major projects and development undertaken by HKSCC and for providing resources for future prospective projects and development.

12.9 *Development fund of the Futures Exchange Group*

The fund was established on 1st July, 1994 to support the development of the Futures Exchange's products, markets and services, and to address the needs of the investing public. Included within the transaction and clearing fees, which are charged on each side of every trade conducted through the Futures Exchange, is an amount of HK\$0.50 which is allocated to the fund through appropriations from the retained surplus account. The fund is used to support the costs of the above mentioned special development projects. Appropriation of the fund requires the prior approval of the SFC.

13 **Commitments**

At 30th June, 1999, HKEC had the following commitments in respect of capital expenditure and under operating leases as follows:

	<i>HK\$'000</i>
(a) Commitments in respect of capital expenditure	
Contracted for	189,510
Authorised but not contracted for	<u>173,679</u>
	<u>363,189</u>

(b) Lease commitments

	Land & Buildings	Equipment	Total
	<i>HK\$'000</i>	<i>HK\$'000</i>	<i>HK\$'000</i>
Commitments under operating leases to make payments in the following year were as follows:—			
Leases expiring within 1 year	19,236	25,916	45,152
Leases expiring after 1 year but within 5 years	39,473	57,412	96,885
Leases expiring after 5 years	<u>12,083</u>	<u>2,063</u>	<u>14,146</u>
	<u>70,792</u>	<u>85,391</u>	<u>156,183</u>

14 Contingent liabilities and off balance sheet exposures

- (i) The Stock Exchange has undertaken to indemnify the Collector of Stamp Revenue against any loss of revenue resulting from any underpayment or default or delay in payment of stamp duty by its members, up to HK\$200,000 in respect of defaults of any one Stock Exchange Shareholder. If in the unlikely event that all of its 487 trading Stock Exchange Shareholders as at 30th June, 1999 had defaulted for amounts in excess of HK\$200,000 each, the maximum liability of the Stock Exchange under the indemnity would have amounted to HK\$97.4 million.
- (ii) SEOCH, a subsidiary of the Stock Exchange, accepts for clearing and acts as a counterparty to every options contract validly concluded on the Stock Exchange. As a counterparty, SEOCH is responsible for premium settlement and contract performance and, consequently, it bears the counterparty credit risk in the event that the Stock Exchange traded options market movements create conditions which lead to options clearing members failing to meet their obligations. SEOCH monitors its exposure through a risk management programme that aims to achieve a prudent balance between market integrity and liquidity, which consists of continuing financial standards requirement for options clearing membership, margin deposits and a reserve fund (not recorded in the Stock Exchange Group's financial statements) contributions from options clearing members. As of 30th June, 1999, SEOCH had not received and had no reason to believe it would receive any claims which may result in a recourse to the reserve fund, nor had SEOCH given any undertakings or issued any warranties in respect of third party liabilities beyond those pursuant to its Options Clearing Rules.
- (iii) The rules of the Stock Exchange provide that all Stock Exchange trading members and dealing partnerships are required to participate in CCASS as broker participants and cause all their Stock Exchange trades in eligible securities to be settled through CCASS. The CNS system interposes HKSCC between broker participants in securities clearing and settlement. As a result, HKSCC provides a form of 'guarantee' to broker participants in respect of Stock Exchange trades accepted for settlement under CNS. If a broker participant fails to fulfil its CNS settlement obligations, HKSCC could be exposed to potential market risk not otherwise included in the statement of net assets. In the course of providing clearing and settlement services to broker participants, HKSCC has a significant concentration of market risk since its broker participants may be affected by economic conditions affecting the securities industry.

HKSCC mitigates its exposure to risk by requiring broker participants to meet the established financial standards for membership required by the Stock Exchange and statutory regulations, monitoring compliance with risk management measures established by HKSCC and requiring broker participants to contribute to the Guarantee Fund.

If a broker participant fails to fulfil its CNS settlement obligations with HKSCC, HKSCC will liquidate that participant's guaranteed securities delivery and receipt obligations and will apply its contribution to the Guarantee Fund to satisfy any net outstanding obligation and/or loss. If a deficiency still exists, HKSCC may apply contributions to the Guarantee Fund made by all other broker participants on a pro-rata basis.

Under the General Rules of CCASS, depositing participants are responsible to HKSCC for any defects affecting securities deposited by them into CCASS. HKSCC is responsible to withdrawing participants for any such defect affecting securities withdrawn by them from CCASS. If a depositing participant fails to fulfil its obligations for defective securities, HKSCC could be exposed to a potential risk not otherwise accounted for in the statement of net assets. The aforesaid mitigating measures and liquidating procedures equally apply to the risk in respect of defective securities attributable to broker participants. Other participants are also required to meet established financial standards and criteria for admission into CCASS and compliance with risk management measures in respect of defective securities established and monitored by HKSCC. Insurance has also been effected to cover the risk of defective securities.

15 United Kingdom Stamp Duty Reserve Tax

HKSCC was contacted by the Stamp Office of the United Kingdom Inland Revenue in 1998 seeking information about how the share dealing systems in Hong Kong currently work in order to establish whether any transfers of shares of United Kingdom ("UK") incorporated companies into CCASS would trigger a liability to United Kingdom Stamp Duty Reserve Tax ("UK SDRT").

UK SDRT is a tax on agreements to transfer chargeable securities (which broadly refer to shares or securities of UK incorporated companies) for money or money's worth unless there is an existing instrument of transfer duly chargeable to UK stamp duty or the agreement is exempted therefrom. UK SDRT is a different tax from the normal UK stamp duty and is intended to remedy UK stamp duty avoidance on paperless transfers of shares without the use of written instruments of transfer, e.g. transfers under an electronic clearing system. UK SDRT has specific application to clearance services in that UK SDRT is triggered whenever chargeable securities are transferred or issued to the clearance service provider or its nominee. As a result of legislative enactment in the UK, as from 1st July, 1996, UK SDRT can apply to overseas transfer agreements, whether or not the transactions are effected in the UK and whether or not any party to the transfer is resident in the UK.

The HKSCC Group has not received any further enquiries from the UK Inland Revenue Stamp Office after the latter's initial requests for information in 1998. No demand for UK SDRT has been received by the HKSCC Group to date and the HKSCC Group is not aware of any legal action taken by the authorities in the UK in this respect to date. HKSCC has requested the assistance of the Government to raise the issue with the relevant UK authorities in order to obtain a satisfactory outcome.

On the basis of legal opinions obtained from UK Queen's Counsel, the HKSCC Group will not have to make any payment for UK SDRT or suffer any penalty in respect thereof.

16 Banking facility*(i) The Stock Exchange Group*

At 30th June, 1999, the Stock Exchange had a HK\$10 million overdraft facility with a major bank in Hong Kong, which was secured by a pledge of the Stock Exchange's time deposits of an equivalent amount at that bank. At 30th June, 1999, none of this overdraft facility had been utilised.

(ii) The HKSCC Group

By agreements dated 15th December, 1998, banking facilities on a committed basis of an aggregate amount of HK\$1,100 million were granted to HKSCC by eleven banks, i.e. each of them has granted HK\$100 million banking facility to HKSCC. The banking facilities are to provide stand-by liquidity to meet HKSCC's obligations in CCASS in circumstances where participants default on their payment obligations. The banking facilities granted and their drawdowns and repayments are on a pro-rata basis for all the eleven lenders. These banking facilities are secured by a debenture creating a floating charge over the assets of HKSCC.

These banking facilities were not utilised during the year ended 30th June, 1999. Legal fees and bank charges on these banking facilities were borne by the Guarantee Fund and not by HKSCC.

17 HKEC was incorporated on 8th July, 1999 as a private company limited by shares and thus was not in existence at 30th June, 1999. Under the terms of proposals made public on 30th July, 1999, HKEC is to issue up to 747,845,000 HKEC Shares in aggregate at HK\$3.88 each to Stock Exchange Shareholders as at the Effective Date, and up to 320,505,000 HKEC Shares in aggregate at HK\$3.88 each to Futures Exchange Shareholders as at the Effective Date. HKEC will also offer cash alternatives to existing members of both Exchanges up to a maximum amount of HK\$1,336 million, of which up to HK\$600 million will be financed by borrowings from three banks, and the balance by means of cash made available to HKEC by the Exchanges. Accordingly, if the cash alternatives are accepted in full by existing members of the Exchanges, HKEC's net assets will be reduced by HK\$1,336 million.

3. PRO FORMA COMBINED INDEBTEDNESS OF HKEC AT 30TH JULY, 1999

Set out below is the pro forma combined statement of indebtedness of HKEC as of the close of business at 30th July, 1999, which takes into account the indebtedness positions of the Stock Exchange Group, the Futures Exchange Group and the HKSCC Group as of the close of business at the same date, as provided by the respective groups' management to HKEC. All material inter-company balances have been eliminated on combination. The objective of preparing this pro forma combined statement of indebtedness is to show the indebtedness position of HKEC had the Overall Proposal as described on page 30 of the Letter from HKEC taken effect and all other circumstances remained as they were. However, the pro forma combined statement of indebtedness set out below is not necessarily indicative of the indebtedness position that would have been incurred by HKEC as of the close of business at 30th July, 1999 had the Overall Proposal taken effect.

As of the close of business at 30th July, 1999, HKEC had the same contingent liabilities and charges over its assets to secure banking facilities as disclosed in notes 12.4(a), 14 and 16 of section 2 above except that the maximum liability under the indemnity as described in note 14(i) of section 2 above amounted to HK\$97.8 million at 30th July, 1999. The Stock Exchange Group and the Futures Exchange Group also receive margin fund deposits from their clearing members in the normal course of their businesses. In addition, as disclosed in note 17 of section 2 above, HKEC obtained bank facilities up to HK\$600 million on 30th July, 1999 and had been no drawdown of these facilities as at that date.

Save as aforesaid, HKEC did not have, as of the close of business at 30th July, 1999, any outstanding mortgages, charges, debentures or other loan capital or bank overdrafts, loans or similar indebtedness or hire purchase or finance lease commitments or any guarantees or other material contingent liabilities.

4. SHARE CAPITAL OF HKEC

The authorised and issued share capital of HKEC as at the Latest Practicable Date were as follows:

<i>Authorised:</i>		<i>HK\$</i>
<u>1,000</u>	HKEC Shares	<u>1,000</u>
<i>Issued and fully paid:</i>		
<u>2</u>	HKEC Shares	<u>2</u>

The two issued HKEC Shares are registered respectively in the names of The Financial Secretary Incorporated and Mr. Rafael Hui. Mr. Rafael Hui holds his one HKEC Share in trust for The Financial Secretary Incorporated.

Subject to and conditional upon the Stock Exchange Scheme and the Futures Exchange Scheme becoming effective, HKEC shall increase its authorised share capital to HK\$2,000,000,000 by the creation of 1,999,999,000 additional HKEC Shares. Accordingly,

upon the Stock Exchange Scheme and the Futures Exchange Scheme becoming effective and based on the number of HKEC Shares in issue on the Latest Practicable Date and assuming that no elections to take the Stock Exchange Cash Alternative or the Futures Exchange Cash Alternative are made, the authorised and issued share capital of HKEC will be as follows:

<i>Authorised:</i>		<i>HK\$</i>
<u>2,000,000,000</u>	HKEC Shares	<u>2,000,000,000</u>
<i>Issued and fully paid:</i>		<i>HK\$</i>
<u>1,068,350,002</u>	HKEC Shares	<u>1,068,350,002</u>

Save as disclosed above or pursuant to the Stock Exchange Proposal and the Futures Exchange Proposal, no share or loan capital of HKEC has been issued or is proposed to be issued for cash or otherwise and no commissions, discounts, brokerages or other special terms have been granted in connection with the issue or sale of any such capital. None of the unissued share or loan capital of HKEC is subject to any options, warrants or conversion rights and it has not been agreed, conditionally or unconditionally, to put any of the unissued share or loan capital of HKEC under any options, warrants or conversion rights.

5. DIRECTORS

The current HKEC Directors are Mr. Charles Lee, Mr. Rafael Hui, Mr. Dannis Lee and Mr. John Strickland.

Mr. LEE Yeh Kwong, Charles is a member of the Executive Council of Hong Kong and one of the founders of the solicitors' firm of Woo, Kwan, Lee & Lo. Mr. Lee was a member of the Council of the Stock Exchange from 1988 to 1994 and became its Chairman from 1992 to 1994. Mr. Lee has also taken up a number of public service positions, including the Chairmanship of the Mandatory Provident Fund Schemes Authority. He was appointed by the Financial Secretary as a director and the Chairman of HKEC on 8th July, 1999.

Mr. Rafael HUI is currently the Secretary for Financial Services. Mr. Hui joined the Government in 1970 and has since served in a number of bureaux (branches) and departments including the Security Branch, Economic Services Branch, Transport Branch and Works Branch. Mr. Hui was awarded Gold Bauhinia Star in 1998.

Mr. LEE Jor Hung, Dannis is the Chairman of DL Brokerage Limited. Mr. Lee has a Bachelor and Master degree in Business Administration and is a fellow of the Hong Kong Institute of Directors. Mr. Lee served as the Vice Chairman of HKSCC and the Stock Exchange between 1995-1997 and 1994-1995, respectively. Mr. Lee was the 1997-1999 Chairman of the Hong Kong Stockbrokers Association and a member of the Securities and Futures Commission Advisory Committee.

Mr. John E. STRICKLAND is a former Chairman of The Hongkong and Shanghai Banking Corporation Limited. He has served as a director of the Mass Transit Railway Corporation, HKSCC and the Airport Authority. Mr. Strickland was awarded the Gold Bauhinia Star in 1998. Mr. Strickland has Honorary Degrees from City University and Hong Kong Polytechnic University. He is active in many community organisations.

The information set out in section 1 "Audited financial information for the year ended 30th June, 1999" in this appendix II to this document has been extracted from the auditors' report and the audited accounts, including the notes to those accounts, of the Stock Exchange Group for the year ended 30th June, 1999 and uses the definitions contained therein.

1. AUDITED FINANCIAL INFORMATION FOR THE YEAR ENDED 30TH JUNE, 1999

Report of the Auditors

To the Council Members

The Stock Exchange of Hong Kong Limited
(Incorporated in Hong Kong with limited liability)

We have audited the financial statements on pages 87 to 108 which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective responsibilities of Council Members and auditors

The Companies Ordinance requires the Council Members to prepare financial statements which 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. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. An audit includes an 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 Council Members in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Exchange's and the Group'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, in all material respects, of the state of affairs of the Exchange and of the Group as at 30 June 1999 and of the surplus and cash flows of the Group for the year then ended and have been properly prepared in accordance with the Companies Ordinance.

Ernst & Young
Certified Public Accountants

Hong Kong, 3rd August, 1999.

Consolidated statement of operations and retained surplus

For the year ended 30 June 1999

	<i>Note</i>	1999 <i>HK\$'000</i>	1998 <i>HK\$'000</i>
Turnover	4	881,609	1,153,533
Operating expenses	5	<u>(610,780)</u>	<u>(557,062)</u>
Surplus before exceptional item		270,829	596,471
Exceptional item	7	<u>—</u>	<u>(150,000)</u>
Surplus before taxation		270,829	446,471
Taxation	8(a)	<u>(19,029)</u>	<u>(57,533)</u>
Surplus for the year	9	251,800	388,938
Retained surplus, beginning of year		742,148	568,824
Transfer from/(to) Development Reserve, net	17	47,701	(65,614)
Transfer to general reserve - property	18	<u>(100,000)</u>	<u>(150,000)</u>
Retained surplus, end of year	10	<u>941,649</u>	<u>742,148</u>

Balance sheets

As at 30 June 1999

	Note	Group		The Exchange	
		1999 HK\$'000	1998 HK\$'000	1999 HK\$'000	1998 HK\$'000
Fixed assets	11	472,810	453,828	256,094	233,649
Investment in subsidiaries	12	—	—	95,978	115,772
Rental, utility and other deposits		8,249	7,534	6,724	6,308
		<u>481,059</u>	<u>461,362</u>	<u>358,796</u>	<u>355,729</u>
Current assets	13	2,189,203	2,208,628	1,533,441	1,465,998
Less: Current liabilities	14	(1,122,802)	(1,376,292)	(494,015)	(660,031)
Net current assets		<u>1,066,401</u>	<u>832,336</u>	<u>1,039,426</u>	<u>805,967</u>
Deferred taxation	8(b)	<u>(34,405)</u>	<u>(23,843)</u>	<u>(34,405)</u>	<u>(23,843)</u>
Net assets		<u>1,513,055</u>	<u>1,269,855</u>	<u>1,363,817</u>	<u>1,137,853</u>
Representing:					
Share capital	15	1	1	1	1
Revaluation reserve	16	113,597	122,197	8,171	16,771
Development Reserve	17	207,808	255,509	207,808	255,509
General reserve - property	18	250,000	150,000	250,000	150,000
Retained surplus		<u>941,649</u>	<u>742,148</u>	<u>897,837</u>	<u>715,572</u>
Equity		<u>1,513,055</u>	<u>1,269,855</u>	<u>1,363,817</u>	<u>1,137,853</u>

Consolidated statement of cash flows

For the year ended 30 June 1999

	<i>Note</i>	1999 <i>HK\$'000</i>	1998 <i>HK\$'000</i>
Net cash inflow/(outflow) from operating activities	25	<u>94,836</u>	<u>(209,557)</u>
Returns on investments and servicing of finance:			
Interest received		136,292	104,915
Interest paid		<u>(14,018)</u>	<u>(14,816)</u>
Net cash inflow from returns on investments and servicing of finance		<u>122,274</u>	<u>90,099</u>
Taxation:			
Profits tax refunded		3,525	43
Profits tax paid		<u>(82,772)</u>	<u>(301)</u>
		<u>(79,247)</u>	<u>(258)</u>
Investing activities:			
Proceeds from disposals of fixed assets		925	32
Additions of fixed assets		(101,885)	(60,795)
Decrease/(Increase) in investments		78,548	(98,454)
Increase in time deposits at banks with maturity over three months		<u>(313,173)</u>	<u>(339,897)</u>
Net cash outflow from investing activities		<u>(335,585)</u>	<u>(499,114)</u>
Decrease in cash and cash equivalents		(197,722)	(618,830)
Cash and cash equivalents, beginning of year		<u>1,094,132</u>	<u>1,712,962</u>
Cash and cash equivalents, end of year		<u>896,410</u>	<u>1,094,132</u>

Analysis of cash and cash equivalents

	1999 <i>HK\$'000</i>	1998 <i>HK\$'000</i>
Time deposits at banks	240,693	356,106
Cash at banks and in hand	2,285	4,421
Cash held for payment of stamp duty	33,448	26,247
Options Clearing Members' margin fund	<u>619,984</u>	<u>707,358</u>
	<u>896,410</u>	<u>1,094,132</u>

Notes to the Financial Statements

For the year ended 30 June 1999

(Amounts expressed in Hong Kong dollars)

1. Organisation status

The Stock Exchange of Hong Kong Limited (the Exchange) is a company incorporated in Hong Kong under the Companies Ordinance with limited liability, and is recognised by the Securities and Futures Commission under the Stock Exchanges Unification Ordinance as the sole exchange with the exclusive right to establish, operate and maintain a stock market in Hong Kong.

Under Section 27A of the Stock Exchanges Unification Ordinance, the Exchange has the duty to ensure an orderly and fair market in securities traded through its facilities. In performing this duty, the Exchange is required to act in the interests of the public, having particular regard to the interests of the investing public, and ensure that where these interests conflict with any other interests that the Exchange is required to serve under any other law, the former shall prevail.

2. Demutualisation of the Exchange

In March 1999, the Financial Secretary issued a white paper on the reform of the securities and futures market in Hong Kong, proposing to demutualise and combine the Exchange, the Hong Kong Futures Exchange Limited (HKFE) and the three clearing houses (the Hong Kong Securities Clearing Company Limited (Hongkong Clearing), the SEHK Options Clearing House Limited (SEOH) and the HKFE Clearing Corporation Limited). This proposed demutualisation would be achieved through the establishment of a new holding company, Hong Kong Exchanges and Clearing Limited (HKEC) and the subsequent mergers of the Exchange, HKFE and Hongkong Clearing respectively, with HKEC.

On 30 July 1999, the Council of the Exchange and the Directors of HKFE approved separate motions to put a proposal to their respective shareholders that they become wholly owned subsidiaries of HKEC. Each of these mergers would be achieved by a scheme of arrangement (Scheme) under section 166 of the Companies Ordinance.

Under the Exchange's Scheme, the Exchange's shares will be cancelled in exchange for 805,000 HKEC shares for each Exchange share. Exchange shareholders will also be offered the opportunity to receive cash in place of some or all of the HKEC shares to which they become entitled, subject to an aggregate overall limit as stipulated in the Scheme. The HKFE will also propose the adoption of a similar Scheme to its shareholders. The consideration under the Schemes represents an exchange ratio as between the Exchange shareholders and HKFE shareholders of 70:30, respectively.

It is also proposed that, pursuant to certain legislation to enable the implementation of this proposed merger, Hongkong Clearing will become a company limited by shares and a wholly owned subsidiary of HKEC.

Each of the above Schemes are conditional upon certain matters which include, inter alia, approval by three-fourths of the members at a meeting to be ordered by the High Court of Hong Kong and the requirement that neither proposal would be capable of taking effect unless the other proposal also becomes effective.

If all conditions are met, it is expected that the Schemes will become effective on or before 31 January 2000.

3. Summary of principal accounting policies

The financial statements have been prepared in accordance with accounting principles generally accepted in Hong Kong and the disclosure requirements of the Hong Kong Companies Ordinance. A summary of the principal accounting policies is set out below:

(a) Basis of consolidation

The consolidated financial statements include the financial statements of the Exchange and its subsidiary companies for the year ended 30 June 1999. All significant intercompany transactions and balances within the Group are eliminated on consolidation.

(b) Subsidiary companies

A subsidiary is a company in which the Exchange has a long term interest of more than 50% of the equity voting rights, or controls more than 50% of its voting power, or controls the composition of its board of directors.

The interests in subsidiary companies are stated at cost unless, in the opinion of the directors, there have been permanent diminutions in values, when they are written down to values determined by the directors.

(c) Turnover and revenue recognition

Revenue is recognised when it is probable that the economic benefits will flow to the Group and when the revenue can be measured reliably, on the following bases:

- (i) transaction levy and trading tariff, on a trade date basis;
- (ii) income from members, listed companies and customers, on the rendering of services;
- (iii) stock information income, on the rendering of services;
- (iv) interest income, on time proportion basis taking into account the principal outstanding and the effective rate of interest applicable; and
- (v) rental income, on a time proportion basis.

(d) Fixed assets and depreciation

Fixed assets, other than the investment property, are stated at cost or valuation less accumulated depreciation. The cost of an asset comprises its purchase price and any directly attributable costs of bringing the asset to its working condition and location for its intended use. Expenditure incurred after the fixed assets have been put into operation, such as repairs and maintenance, is normally charged to the statement of operations in the period in which it is incurred. In situations where it can be clearly demonstrated that the expenditure has resulted in an increase in the future economic benefits expected to be obtained from the use of the fixed asset, the expenditure is capitalised as an additional cost of the fixed asset.

When assets are sold or retired, their cost and accumulated depreciation are eliminated from the accounts and any gain or loss resulting from their disposal, being the difference between the sales proceeds and the carrying amount of the relevant asset, is included in the statement of operations. Any related revaluation surpluses are transferred from fixed assets revaluation reserve to retained surplus.

Project development expenditure incurred on specific projects is carried forward when its recoverability can be foreseen with reasonable assurance. On completion of the projects, this expenditure will be either capitalised as fixed assets and depreciated in accordance with the above stated depreciation policy or charged to the statement of operations.

Depreciation is calculated on the straight-line basis to write off the cost of each asset over its estimated useful life. The principal annual rates used for this purpose are as follows:

Land held under long-term leases	0.1% to 0.8% (Unexpired lease terms)
Buildings	4%
Leasehold improvements, furniture and equipment	20%
Computer trading system	14.3% to 33.3%
Motor vehicles	33.3%

(e) **Investment property**

Investment property is an interest in land and building in respect of which construction work and development have been completed and which is intended to be held on a long term basis for its investment potential. Such property is not depreciated and is stated at its open market value on the basis of an annual professional valuation performed at the end of each financial year. The change in the value of investment property is dealt with as a movement in the investment property revaluation reserve. If the total of this reserve is insufficient to cover a deficit, on a portfolio basis, the excess of the deficit is charged to the statement of operations.

On disposal of an investment property, the relevant portion of the investment property revaluation reserve realized in respect of previous valuations is released to the statement of operations.

(f) **Investments**

Investments, which are unlisted, are stated at cost less provisions for any permanent diminutions in values. Income from investments is accounted for to the extent of interest received or receivable.

(g) **Listed securities**

Listed securities deposited for margin and collateral purposes are stated at the closing prices quoted on the Exchange as at the balance sheet date.

(h) **Deferred taxation**

Deferred taxation is provided, using the liability method, on all significant timing differences to the extent it is probable that the liability will crystallise in the foreseeable future. A deferred tax asset is not recognised until its realisation is assured beyond reasonable doubt.

(i) **Foreign currency transactions**

Companies within the Group maintain their books in Hong Kong dollars. Foreign currency transactions are recorded at the applicable rates of exchange ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the applicable rates of exchange ruling at that date. Exchange differences are dealt with in the statement of operations.

(j) **Leases**

Leases where substantially all the rewards and risks of ownership of the assets remain with the leasing company are accounted for as operating leases. Rentals applicable to such operating leases are charged to the statement of operations on the straight-line basis over the lease terms.

(k) **Cash equivalents**

Cash equivalents represent short term highly liquid investments which are readily convertible into known amounts of cash and which were within three months of maturity when acquired, less advances from banks repayable within three months from the date of the advance.

(l) **Related parties**

Parties are considered to be related if one party has the ability, directly or indirectly, to control the other party, or exercise significant influence over the other party in making financial and operating decisions. Parties are also considered to be related if they are subject to common control or common significant influence.

4. **Turnover**

	1999 HK\$'000	1998 HK\$'000
Transaction levy — the Exchange's entitlement*	223,049	447,832
Listing fees	196,721	215,902
Stock information income	209,527	227,387
Income from Members		
— monthly subscriptions and others	100,674	106,340
— options trading related activities	10,554	12,378
— unclaimed brokerage	777	20,634
Interest income**	123,509	99,036
Rental income	2,184	2,184
Recovery of Brokers' Fidelity Insurance (Note 5)	6,436	7,903
Others	8,178	13,937
	<u>881,609</u>	<u>1,153,533</u>

* The Exchange was entitled to 63.64% (1997/98: 63.64%) of the transaction levy received, one seventh of which was transferred to the Development Reserve, while the SFC was entitled to 36.36% (1997/98: 36.36%).

** Interest income was net of interest expenses paid to Members as follows:

	1999 HK\$'000	1998 HK\$'000
Total interest income	135,852	114,794
Less: interest paid to Members on certain temporary receipts	(3,317)	(5,061)
interest paid to Options Clearing Members on margin deposits	(9,026)	(10,697)
	<u>123,509</u>	<u>99,036</u>

5. Operating expenses

	1999 <i>HK\$'000</i>	1998 <i>HK\$'000</i>
Staff costs	269,550	256,382
Trading technology and computer maintenance*	137,133	107,499
Accommodation*	39,998	39,271
Administration expenses*	44,126	39,881
Professional fees	27,146	25,356
Auditors' remuneration	500	650
Brokers' Fidelity Insurance**	18,949	23,045
Depreciation of fixed assets	70,443	58,293
Loss on disposal of fixed assets	2,935	6,685
	<u>610,780</u>	<u>557,062</u>

* The following charges under operating leases have been included in the operating expenses:—

	1999 <i>HK\$'000</i>	1998 <i>HK\$'000</i>
Trading technology and computer maintenance		
— equipment rental	50,507	41,777
Accommodation		
— rental charges of office premises	24,590	23,740
Administration expenses		
— equipment rental	<u>1,120</u>	<u>1,096</u>
	<u>76,217</u>	<u>66,613</u>

** The Exchange has taken out a Brokers' Fidelity Insurance policy for its Members for losses from theft by employees of the Members, defective securities and other errors and omissions, and recovers approximately one-third of the premium from its Members.

6. Council members' and senior executives' emoluments

- (a) The aggregate amount of Council members' emoluments disclosed pursuant to section 161 of the Companies Ordinance was as follows:

	1999 HK\$'000	1998 HK\$'000
Fees	—	—
Other emoluments to Chief Executive:		
Salary inclusive of bonus and housing allowance	5,647	5,966
Vested interest in employer's contributions to provident fund	<u>537</u>	<u>399</u>
	<u>6,184</u>	<u>6,365</u>

No emoluments were paid to the Chairman, nor to other elected or lay members of the Council of the Exchange.

- (b) The aggregate amount of emoluments paid to the five highest paid senior executives (including the Chief Executive who is a member of the Council) was as follows:

	1999 HK\$'000	1998 HK\$'000
Salary inclusive of bonus and housing allowance	19,675	19,065
Vested interest in employer's contributions to provident fund	<u>1,765</u>	<u>1,619</u>
	<u>21,440</u>	<u>20,684</u>

The above remuneration is analysed as follows:—

	Number of executives	
	1999	1998
In HK\$		
2,500,001 — 3,000,000	1	2
3,500,001 — 4,000,000	1	1
4,000,001 — 4,500,000	2	—
4,500,001 — 5,000,000	—	1
6,000,001 — 6,500,000	<u>1</u>	<u>1</u>
	<u>5</u>	<u>5</u>

7. Exceptional item

As a result of the turmoil in the Asian markets in late 1997, and the subsequent failure of certain institutions connected with the securities markets, the Government, the SFC and the Exchange announced on 26 January 1998 that they would review the statutory limit of the Unified Exchange Compensation Fund ("Fund") in the case of C A Pacific Securities Limited and that the SFC and the Exchange would make a contribution to the Fund as soon as on-going action to put the SFC into a position to make this contribution is complete. In this connection during the year ended 30 June 1998, the Exchange has resolved to inject \$150 million to the Fund to meet additional compensation to be payable to certain public investors.

8. Taxation

- (a) Hong Kong profits tax has been provided at the rate of 16% (1998: 16%) on the estimated assessable profits arising in Hong Kong during the year.

Provision for taxation in respect of assessable profits for the year:

	1999 HK\$'000	1998 HK\$'000
Provision for the year	19,271	52,727
Under/(Over) provision for prior year	(7,279)	2,319
Refund for prior year	(3,525)	—
Deferred taxation	<u>10,562</u>	<u>2,487</u>
	<u>19,029</u>	<u>57,533</u>

- (b) Deferred taxation in the balance sheets:

	Group and The Exchange	
	1999 HK\$'000	1998 HK\$'000
Balance at beginning of year	23,843	21,356
Provision during the year	<u>10,562</u>	<u>2,487</u>
Balance at end of year	<u>34,405*</u>	<u>23,843*</u>

* The amount represents the tax effect of accelerated tax depreciation allowances on fixed assets.

The surpluses arising on the revaluation of properties (see Note 16) do not constitute a timing difference for taxation purposes as realisation of these surpluses will not give rise to any tax liability.

9. Surplus for the year

The consolidated surplus includes a surplus of \$234,564,000 (1998: \$378,363,000) dealt with in the financial statements of the Exchange.

10. Retained surplus

Under the Memorandum and Articles of Association of the Exchange, the Exchange shall not pay any dividends to its Members. The assets of the Exchange will only be available for distribution among its Members upon winding up of the Exchange.

11. Fixed assets

(a) Movements of fixed assets were:

Group	Investment property HK\$'000	Land & buildings HK\$'000	Leasehold improvements, Computer		Motor vehicles HK\$'000	Total HK\$'000
			furniture & equipment HK\$'000	trading system HK\$'000		
Cost or valuation						
Beginning of year	25,000	235,096	82,195	495,196	1,056	838,543
Additions	—	—	69	101,018	798	101,885
Disposals	—	—	(5,017)	(13,944)	(872)	(19,833)
Deficit on revaluation	(8,600)	—	—	—	—	(8,600)
End of year	<u>16,400</u>	<u>235,096</u>	<u>77,247</u>	<u>582,270</u>	<u>982</u>	<u>911,995</u>
Representing:						
At cost	—	65,096	77,247	582,270	982	725,595
At valuation	<u>16,400</u>	<u>170,000</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>186,400</u>
	<u>16,400</u>	<u>235,096</u>	<u>77,247</u>	<u>582,270</u>	<u>982</u>	<u>911,995</u>
Accumulated depreciation						
Beginning of year	—	14,917	58,350	310,535	913	384,715
Provision for the year	—	3,463	7,875	58,999	106	70,443
Write-back on disposals	—	—	(4,464)	(10,637)	(872)	(15,973)
End of year	<u>—</u>	<u>18,380</u>	<u>61,761</u>	<u>358,897</u>	<u>147</u>	<u>439,185</u>
Net book value						
End of year	<u>16,400</u>	<u>216,716</u>	<u>15,486</u>	<u>223,373</u>	<u>835</u>	<u>472,810</u>
Beginning of year	<u>25,000</u>	<u>220,179</u>	<u>23,845</u>	<u>184,661</u>	<u>143</u>	<u>453,828</u>

The Exchange	Investment property HK\$'000	Leasehold improvements, furniture & equipment HK\$'000	Computer		Motor vehicles HK\$'000	Total HK\$'000
			trading system HK\$'000			
Cost or valuation						
Beginning of year	25,000	81,650	495,196	1,056	602,902	
Additions	—	69	101,018	798	101,885	
Disposals	—	(5,017)	(13,944)	(872)	(19,833)	
Deficit on revaluation	(8,600)	—	—	—	(8,600)	
End of year	<u>16,400</u>	<u>76,702</u>	<u>582,270</u>	<u>982</u>	<u>676,354</u>	
Representing:						
At cost	—	76,702	582,270	982	659,954	
At valuation	<u>16,400</u>	<u>—</u>	<u>—</u>	<u>—</u>	<u>16,400</u>	
	<u>16,400</u>	<u>76,702</u>	<u>582,270</u>	<u>982</u>	<u>676,354</u>	
Accumulated depreciation						
Beginning of year	—	57,805	310,535	913	369,253	
Provision for the year	—	7,875	58,999	106	66,980	
Write-back on disposals	—	(4,464)	(10,637)	(872)	(15,973)	
End of year	<u>—</u>	<u>61,216</u>	<u>358,897</u>	<u>147</u>	<u>420,260</u>	
Net book value						
End of year	<u>16,400</u>	<u>15,486</u>	<u>223,373</u>	<u>835</u>	<u>256,094</u>	
Beginning of year	<u>25,000</u>	<u>23,845</u>	<u>184,661</u>	<u>143</u>	<u>233,649</u>	

(b) Particulars of properties

Particulars of the investment property and the land and buildings were as follows:

Location	Leases	1999 HK\$'000	1998 HK\$'000
Investment property:			
5th Floor of Hong Kong Plaza, 168-191 Connaught Road West, Hong Kong	341/15,000 shares of Inland Lot No.289 with lease terms of 75 years from 1904 and renewable for a further term of 75 years, and Inland Lot No.302 with lease term of 999 years from 1903	16,400 (i) and (ii)	25,000
		<u>16,400</u>	<u>25,000</u>
Land and buildings:			
17th Floor of World-Wide House, 19 Des Voeux Road, Central, Hong Kong	1,936/123,000 shares of Inland Lot No.8432 with lease term of 75 years from 1978 and renewable for a further term of 75 years	100,096 (iii)	100,096
Upper Ground Floor, 1st & 2nd Floors of V-Heun Building, 128-140 Queen's Road Central, Hong Kong	29/252 shares of Inland Lot No. 161, 165, 167 with lease terms of 999 years from 1843 and 1844	135,000 (iv)	135,000
		<u>235,096</u>	<u>235,096</u>

- (i) This property was held by the Exchange; the other properties were held by its subsidiaries.
- (ii) The investment property was stated at its open market value as at 30 June 1999 as determined by Jones Lang LaSalle, an independent firm of qualified real estate valuers.
- (iii) Part of this property was stated at its open market value as at 30 June 1993 as determined by Chesterton Petty Limited, an independent firm of qualified real estate valuers.
- (iv) The property was stated at its open market value as at 30 June 1995 as determined by Chesterton Petty Limited, an independent firm of qualified real estate valuers.
- (v) The carrying amount of the land and buildings of the Group as at 30 June 1999 would have been \$89,534,000 (1998 - \$91,211,000) had the land and buildings been carried at cost less accumulated depreciation.

12. Investment in subsidiaries

In the Exchange's balance sheet, investment in subsidiaries comprised:

	The Exchange	
	1999 HK\$'000	1998 HK\$'000
Unlisted shares, at cost	45,156	45,156
Advances to subsidiaries	62,888	76,183
Advances from subsidiaries	<u>(12,066)</u>	<u>(5,567)</u>
	<u>95,978</u>	<u>115,772</u>

The advances to/(from) subsidiaries were unsecured and non-interest bearing. The Exchange has agreed that it will not demand repayment from the subsidiaries until the subsidiaries are financially capable of doing so.

The Exchange has agreed to grant a \$10 million credit facility to its subsidiary, SEOCH, with the advances to be in the form of subordinated loans upon draw down. As at and for the year ended 30 June 1999, none of this facility had been utilised.

Details of the subsidiaries as at 30 June 1999 were:

Name of company	Place of incorporation and operations	Paid up capital HK\$	Percentage of ownership directly held	Principal activity
The SEHK Options Clearing House Limited	Hong Kong	1,000,000	100	Clearing House for options contracts traded on the Exchange
Stock Exchange Information Services Limited	Hong Kong	100	100	Sale of market information and supervision of the editorial policy of The Monthly Bulletin
Prime View Company Limited	Hong Kong	20	100	Property holding
The Stock Exchange Club Limited	Hong Kong	8	100	Property holding
The Stock Exchange Nominee Limited	Hong Kong	2	100	Nominee services

13. Current assets

	Group		The Exchange	
	1999 HK\$'000	1998 HK\$'000	1999 HK\$'000	1998 HK\$'000
Accounts receivable	69,302	63,961	49,608	43,531
Prepayments	11,371	8,574	11,371	8,574
Investments (see note (a))	19,906	98,454	19,906	98,454
Time deposits at banks	1,282,541	1,084,781	1,269,862	1,074,726
Cash at banks and in hand	<u>2,285</u>	<u>4,421</u>	<u>479</u>	<u>481</u>
	<u>1,385,405</u>	<u>1,260,191</u>	<u>1,351,226</u>	<u>1,225,766</u>
Options Clearing Members' margin fund (see note (b))	<u>619,984</u>	<u>707,358</u>	<u>—</u>	<u>—</u>
SFC's share of transaction levy receivable	13,471	10,608	13,471	10,608
Stamp duty receivable	54,757	23,231	54,757	23,231
Cash held for payment of stamp duty	<u>33,448</u>	<u>26,247</u>	<u>33,448</u>	<u>26,247</u>
	<u>101,676</u>	<u>60,086</u>	<u>101,676</u>	<u>60,086</u>
Temporary receipt assets (see note (c))	<u>82,138</u>	<u>180,993</u>	<u>80,539</u>	<u>180,146</u>
	<u>2,189,203</u>	<u>2,208,628</u>	<u>1,533,441</u>	<u>1,465,998</u>

(a) Investments

Investments represent unlisted fixed rate instruments denominated in Hong Kong dollars bearing interest at 9.4% per annum and maturing within one year.

(b) Options Clearing Members' margin fund

The Options Clearing Members' margin fund represents the balance of receivables from Options Clearing Members and Hongkong Clearing due for settlement in cash immediately after the balance sheet date, cash and shares of listed securities deposited by Options Clearing Members for margin and collateral purposes held in bank accounts of SEOCH and CCASS, the Central Clearing & Settlement System, in the name of SEOCH. These funds were recorded as assets of SEOCH with an offsetting liability to Options Clearing Members who provided deposits for the fund (see Note 14). A breakdown of these funds was:

	Group	
	1999	1998
	HK\$'000	HK\$'000
Bank deposits		
— call and time deposits maturing in less than three months upon inception	329,688	359,580
— bank current accounts	917	857
Listed securities held	210,835	325,783
Receivables	<u>78,544</u>	<u>21,138</u>
	<u>619,984</u>	<u>707,358</u>

(c) Temporary receipt assets

Temporary receipt assets represent deposits at banks held by the Exchange on behalf of Members, deposits from Members relating to options trading, tenants' deposits and stamp duty deposits. These are ultimately refundable and the corresponding liabilities are shown in Note 14.

14. Current liabilities

	Group		The Exchange	
	1999 HK\$'000	1998 HK\$'000	1999 HK\$'000	1998 HK\$'000
Accounts payable and accruals	54,959	93,572	54,644	92,683
Deferred revenue (see note (a))	93,230	92,688	88,339	87,201
Tax payable	20,815	91,595	18,817	89,915
	<u>169,004</u>	<u>277,855</u>	<u>161,800</u>	<u>269,799</u>
Options Clearing Members' margin deposits (see note (b))	<u>619,984</u>	<u>707,358</u>	—	—
Payable to Unified Exchange Compensation Fund (see Note 7)	<u>150,000</u>	<u>150,000</u>	<u>150,000</u>	<u>150,000</u>
SFC's share of transaction levy payable	13,471	10,608	13,471	10,608
Stamp duty payable	<u>88,205</u>	<u>49,478</u>	<u>88,205</u>	<u>49,478</u>
	<u>101,676</u>	<u>60,086</u>	<u>101,676</u>	<u>60,086</u>
Temporary receipts refundable	<u>82,138</u>	<u>180,993</u>	<u>80,539</u>	<u>180,146</u>
	<u>1,122,802</u>	<u>1,376,292</u>	<u>494,015</u>	<u>660,031</u>

(a) **Deferred revenue**

Deferred revenue comprised annual listing fees received in advance, payments received for undelivered services in relation to the sales of stock market information and telecommunication line rental for the second and third terminals.

(b) **Options Clearing Members' margin deposits**

Options Clearing Members' margin deposits represent the net balances due to Options Clearing Members as at the balance sheet date in respect of premium, stock settlement amounts, margin required on uncovered open short options contracts and pending stock positions arising from exercise and assignment of options contracts, and shares of underlying stocks deposited for collateral purposes. A breakdown of these deposits was:

	Group	
	1999 HK\$'000	1998 HK\$'000
Cash deposits	331,373	361,919
Listed securities held	210,835	325,783
Payables	<u>77,776</u>	<u>19,656</u>
	<u>619,984</u>	<u>707,358</u>

15. Share capital

	The Exchange	
	1999 HK\$	1998 HK\$
Authorised		
1,200 'A' shares of \$1 each	<u>1,200</u>	<u>1,200</u>
Issued		
929 'A' shares of \$1 each fully paid	<u>929</u>	<u>929</u>

16. Revaluation reserve

Movements of revaluation reserve were as follows:—

	Group		The Exchange	
	1999 HK\$'000	1998 HK\$'000	1999 HK\$'000	1998 HK\$'000
Property revaluation reserve (property for own use)				
Beginning and end of year	<u>105,426</u>	<u>105,426</u>	<u>—</u>	<u>—</u>
Investment property revaluation reserve				
Beginning of year	16,771	24,771	16,771	24,771
Deficit on revaluation	<u>(8,600)</u>	<u>(8,000)</u>	<u>(8,600)</u>	<u>(8,000)</u>
End of year	<u>8,171</u>	<u>16,771</u>	<u>8,171</u>	<u>16,771</u>
Total	<u>113,597</u>	<u>122,197</u>	<u>8,171</u>	<u>16,771</u>

17. Development Reserve

Movements of Development Reserve were as follows:—

	Group and The Exchange	
	1999 HK\$'000	1998 HK\$'000
Beginning of year	<u>255,509</u>	<u>183,794</u>
Transfer from/(to) retained surplus		
— Further automation of trading system (see note (a))	(71,447)	—
— Y2K sponsorship to HK Government (see note (a))	(3,125)	—
— Excess of transaction levy (see note(b))	—	234,667
— One-seventh of the Exchange's share of transaction levy (see note(c))	26,871	—
— Payable to Unified Exchange Compensation Fund (see Note 7)	—	(150,000)
— Upgrade of AMS trading system (see note (d))	—	<u>(19,053)</u>
	<u>(47,701)</u>	<u>65,614</u>
One-seventh of the Exchange's share of transaction levy	—	<u>6,101</u>
End of year	<u><u>207,808</u></u>	<u><u>255,509</u></u>

- (a) During the year, approximately \$74,572,000 was utilized from the Development Reserve, \$71,447,000 of which was capitalised as additions to fixed assets for the further automation of the trading system to improve market access by investors; and \$3,125,000 representing Hong Kong Government sponsorship for Y2K was taken to the statement of operations.
- (b) The last financial year's balance represented the excess of transaction levy over one-third of the Exchange's budgeted recurrent expenses appropriated to the Development Reserve in accordance with the budgetary guidelines approved by the Financial Secretary in May 1996. There was no excess levy in the current financial year.
- (c) The Exchange is required to transfer to the Development Reserve one-seventh of the Exchange's share of income from transaction levy (representing 9.09% of the total transaction levy received), less any applicable profits tax, in accordance with a new budgetary guideline provided by the Financial Secretary in April 1998. During the year, approximately \$26,871,000 (after netting off the provision for Hong Kong profits tax of approximately \$5,099,000) was transferred to the Development Reserve.
- (d) Approximately \$19,053,000 was utilised from the Development Reserve and incurred as additions to fixed assets for upgrading the AMS trading system to cope with the increased trading volume in the last financial year.

18. General reserve — property

	Group and The Exchange	
	1999	1998
	HK\$'000	HK\$'000
Beginning of year	150,000	—
Transfer from retained surplus	<u>100,000</u>	<u>150,000</u>
End of year	<u>250,000</u>	<u>150,000</u>

During the year, \$100 million was appropriated from the retained surplus to the general reserve - property for the purpose of acquiring office premises in the future.

19. Related party transactions

The Group had the following related party transactions on normal commercial terms with Hongkong Clearing of which certain Council Members of the Exchange were directors:

	Group	
	1999	1998
	HK\$'000	HK\$'000
Transactions with related parties		
Rental income for office premises (see note (a))	288	288
Front end and commitment fee for the \$100 million loan facility (see note (b))	312	—
Fees reimbursed (see note (c))	552	60
Fees paid (see note (d))	<u>(3)</u>	<u>(204)</u>
	<u>1,149</u>	<u>144</u>
Balance with a related party		
Deposit paid (see note (e))	<u>(1,000)</u>	<u>(1,000)</u>

(a) The Exchange has charged Hongkong Clearing a fixed rental per month for the use of the board room of the Exchange. The charge is based on fair market rental.

(b) On 15 December 1998, the Exchange terminated an agreement with Hongkong Clearing to provide it with a \$150 million term loan facility. On the same date, a similar agreement was entered into between the above-mentioned parties, together with ten banks, five of which are subscribers to Hongkong Clearing's Memorandum and Articles of Association. Under the agreement, the Exchange and each of the other ten banks agreed to provide a \$100 million revolving loan facility bearing interest at Hong Kong Dollar Interbank Offered Rate (HIBOR) plus 2 percent per annum and secured by a debenture in favour of HSBC International Trustee Limited acting as a trustee for the eleven lenders. As at and for the year ended 30 June 1999, none of this facility had been utilised by Hongkong Clearing (1998: Nil). The Exchange has received a flat front end fee at 0.25 per cent of the loan facility from Hongkong Clearing upon signing of the agreement. The Exchange is also entitled to a commitment fee at a rate of 0.125% per annum payable in arrear at the end of each 3-month period.

(c) This represents reimbursements from Hongkong Clearing in respect of various administrative charges.

(d) The Group paid custodian fees for custodian services and agency fees for supervision services of physical settlement of trades provided by Hongkong Clearing.

- (e) The deposit represents a refundable admission fee paid to Hong Kong Clearing in respect of SEOCH's admission as a CCASS participant.

20. Lease commitments

The amounts of operating lease commitments payable within the coming twelve months were as follows:

	Group and The Exchange			
	1999		1998	
	Land & Buildings HK\$'000	Equipment HK\$'000	Land & Buildings HK\$'000	Equipment HK\$'000
Leases which expire:				
Within one year	6,535	25,916	59	3,387
In the second to fifth years inclusive	4,128	56,033	15,634	47,015
After five years	<u>12,083</u>	<u>2,063</u>	<u>9,445</u>	<u>—</u>
	<u>22,746</u>	<u>84,012</u>	<u>25,138</u>	<u>50,402</u>

21. Banking facility

As at 30 June 1999, the Exchange had a \$10 million overdraft facility with a major bank in Hong Kong, which was secured by a pledge of the Exchange's time deposits of an equivalent amount at that bank. As at 30 June 1999, none of this overdraft facility had been utilised (1998: nil).

22. Contingent liabilities and off balance sheet exposures

The Exchange has undertaken to indemnify the Collector of Stamp Revenue against any loss of revenue resulting from any underpayment or default or delay in payment of stamp duty by its Members, up to \$200,000 in respect of defaults of any one Member. In the unlikely event that all of its 487 trading Members as at 30 June 1999 had defaulted for amounts in excess of \$200,000 each, the maximum liability of the Exchange under the indemnity would have amounted to \$97.4 million. (1998: \$98.4 million)

The Exchange has subscribed to the Memorandum of Association of Hongkong Clearing. In doing so, it has undertaken to contribute up to \$25 million in the event of it being wound up and having a net deficit after the winding-up proceedings.

SEOCH accepts for clearing and acts as a counter party to every options contract validly concluded on the Exchange. As a counter party, SEOCH is responsible for premium settlement and contract performance and, consequently, it bears the counter party credit risk in the event that the Exchange traded options market movements create conditions which could lead to Options Clearing Members failing to meet their obligations. SEOCH monitors its exposure through a risk management programme that aims to achieve a prudent balance between market integrity and liquidity, which consists of continuing financial standards requirement for options clearing membership, margin deposits and Reserve Fund (not recorded in the Group's financial statements) contributions from Clearing Members. As of the balance sheet date, SEOCH had not received and had no reason to believe it would receive any claims which may result in a recourse to the Reserve Fund, nor had SEOCH given any undertakings or issued any warranties in respect of third party liabilities beyond those pursuant to its Options Clearing Rules.

23. Capital commitments

Capital commitments not provided for in the financial statements were as follows:

	Group and The Exchange	
	1999	1998
	<i>HK\$'000</i>	<i>HK\$'000</i>
Contracted but not provided for	179,483	3,009
Authorised by the Council but not contracted for	<u>153,538</u>	<u>479,491</u>
	<u>333,021</u>	<u>482,500</u>
Representing:		
Acquisition of:		
Computer trading system	333,021	481,959
Leasehold improvements	—	53
Office equipment	<u>—</u>	<u>488</u>
	<u>333,021</u>	<u>482,500</u>

24. Provident fund scheme

The Group operates a defined contribution provident fund for its employees, which is managed by HSBC Asset Management Bahamas Ltd., an independent trustee. The Group makes a monthly contribution to the scheme of an amount of 5% to 12.5% of the employees' basic salaries, whereas the employees contribute 0 to 5% of their basic salaries. The employees are entitled to 100% of their own contribution and the accrued interest thereon, and 100% of the employers' contribution and the accrued interest thereon upon retirement or leaving the Group after completing ten years of service, or between 30% to 90% of such contributions after completing three to nine years of service. The forfeited contributions made by the Group and the related accrued interest are credited to a reserve account of the fund rather than being applied to reduce the Group's contributions. During the year, the aggregate amount of employers' contributions made by the Group was approximately \$24,930,000 (1998: \$22,635,000).

25. Reconciliation of surplus before taxation to net cash inflow/(outflow) from operating activities

	1999 HK\$'000	1998 HK\$'000
Surplus before taxation	270,829	446,471
Transfer to payable to Unified Exchange Compensation Fund	—	150,000
Interest income	(135,852)	(114,794)
Interest expense	12,343	15,758
Depreciation of fixed assets	70,443	58,293
Loss on disposal of fixed assets	2,935	6,685
Transaction levy credited directly to Development Reserve	—	7,263
Increase in rental, utility and other deposits	(715)	(493)
(Increase)/Decrease in accounts receivable	(5,781)	55,896
Increase in prepayments	(2,797)	(768)
(Increase)/Decrease in SFC's share of transaction levy receivable	(2,863)	37,293
(Increase)/Decrease in stamp duty receivable	(31,526)	135,430
(Decrease)/Increase in accounts payable and accruals	(36,938)	30,008
Increase in deferred revenue	542	22,225
Decrease in Options Clearing Members' margin deposit	(87,374)	(793,326)
Increase/(Decrease) in SFC's share of transaction levy payable	2,863	(37,293)
Increase/(Decrease) in stamp duty payable	<u>38,727</u>	<u>(228,205)</u>
Net cash inflow/(outflow) from operating activities	<u>94,836</u>	<u>(209,557)</u>

26. Subsequent event

As part of the proposed demutualisation, as set out in note 2 to the financial statements, the Exchange considered it in the best interests of the Exchange and its Members for the demutualisation proposals to include an option for the Exchange Members to receive cash from HKEC in consideration of the cancellation of their shares in the Exchange, instead of, or as well as, receiving shares in HKEC. Pursuant to a letter dated 30 July 1999, issued by the Exchange to HKEC, the Exchange has agreed to maintain an amount of HK\$669 million (the "Funded Amount") as a reserve which would not be utilised for any purpose in the business of the Exchange other than for the purposes of making available funding to the HKEC for the purposes of fulfilling the cash alternative as mentioned above. In this connection, the Exchange has agreed, subject to certain conditions, to provide a loan facility to HKEC up to the Funded Amount. Alternatively, the Funded Amount may be made available to HKEC on the payment of a dividend to HKEC by the Exchange immediately after the scheme of arrangement becomes effective.

27. Comparative figures

Certain comparative figures have been reclassified to conform with the current year's presentation.

2. FIVE YEAR TRADING RECORD SUMMARY OF THE STOCK EXCHANGE GROUP

	1999	As at 30th June,			1995
		1998	1997	1996	
			(\$million)		
Financial					
Turnover	882	1,154	790	450	400
Transfer to Unified Exchange Compensation Fund	—	150	N/A	N/A	N/A
Surplus for the year	252	389	245	20	42
Transfer to Development Reserve, net	48	66	184	N/A	N/A
Transfer to general reserve - property	100	150	N/A	N/A	N/A
Share capital	—	—	—	—	—
Revaluation reserve	114	122	130	130	136
Retained surplus	942	742	569	507	487
Capital expenditure	102	61	10	29	233
Net assets employed	1,513	1,270	883	637	623
Staff costs	270	256	258	205	177
Trading technology and computer maintenance	137	107	63	50	25
Accommodation	40	39	36	36	38
Administration expenses	47	47	39	31	30
Brokers' Fidelity Insurance	19	23	26	27	25
Professional fees	27	26	15	9	14
Government levies					
Stamp duty collected for Government	3,628	9,033	6,968	3,120	2,542
SFC transaction levy	128	376	294	128	103

3. INDEBTEDNESS

As at the close of business on 30th July, 1999 the Stock Exchange Group had a bank overdraft facility of \$10 million which was secured by a pledge of the Stock Exchange's time deposits in an equivalent amount. As at 30th July, 1999 there was no drawdown of this facility.

In addition, at 30th July, 1999 the Stock Exchange Group had contingent liabilities in respect of the following:

- (a) an undertaking to indemnify the Collector of Stamp Revenue up to \$200,000 for each Stock Exchange member against any loss of revenue resulting from any underpayment, default or delay in payment of stamp duty by them. The maximum liability under the indemnity amounted to \$97.8 million as at 30th July, 1999;
- (b) an undertaking to contribute up to \$25 million in the event that HKSCC winds up and has a net deficit after the winding up proceedings; and
- (c) counterparty risk in the event that any Options Clearing Member fails to meet its obligations in premium settlement and contract performance. As of 30th July, 1999 the Group had not received and had no reason to believe it would receive any claims which may result in any recourse to the Group.

As at 30th July, 1999, the Stock Exchange, along with a group of ten banks, had provided a secured interest-bearing revolving loan facility of \$100 million each (\$1,100 million in aggregate) to HKSCC under an agreement made on 15th December, 1998. As at 30th July, 1999, there was no drawdown of this facility by HKSCC.

Save as aforesaid and apart from intra-group liabilities, the Stock Exchange Group did not have, at the close of business on 30th July, 1999, any outstanding mortgages, charges, debentures or other loan capital or bank overdrafts, loans or similar indebtedness or hire purchase or finance lease commitments or any guarantees or other material contingent liabilities.

4. SHARE CAPITAL OF THE EXCHANGE

The authorised and issued share capital of the Stock Exchange as at the Latest Practicable Date were as follows:

	<i>HK\$</i>
<i>Authorised:</i>	
<u>1,200</u> Stock Exchange Shares	<u>1,200</u>
<i>Issued and fully paid:</i>	
<u>929</u> Stock Exchange Shares	<u>929</u>

The Stock Exchange Scheme Shares rank *pari passu* in all respects.

Save for the Stock Exchange Shares to be issued to HKEC pursuant to the Stock Exchange Scheme, since 30th June, 1999, the date to which the latest audited financial statements were made up, no share or loan capital of the Stock Exchange has been issued or is proposed to be issued for cash or otherwise and no commissions, discounts, brokerages or other special terms have been granted in connection with the issue or sale of any such capital. None of the unissued share or loan capital of the Stock Exchange is subject to any options, warrants or conversion rights and it has not been agreed, conditionally or unconditionally, to put any of the unissued share or loan capital of the Stock Exchange under any options, warrants or conversion rights.

5. MATERIAL CHANGES

The audited consolidated financial statements of the Stock Exchange Group for the year ended 30th June, 1999 were approved by the Council on 3rd August, 1999 and are incorporated in this appendix II to this document.

There has been no material change in the financial or trading position or prospects of the Stock Exchange Group since 30th June, 1999.

6. COUNCIL MEMBERS

The current Council Members are:—

Au Chong Kit, Stanley

AW, Allan

BECZAK, Thaddeus

BOKHARY, Syed Bagh Ali Shah

CHAN Cho Chak, John

CHAN, Henry

CHEN Po Sum

CHENG Mo-chi, Moses

CHEUK Siu Ying, Venice

CHEUNG Tin Sang

CHEUNG Wah Fung, Christopher

CHU HO Miu Hing

FONG Hup

HUI CHIU Chung, Stephen

LEE Hon Chiu

LEE Yu Leung

LO Ka Shui

LO Tak Shing, Andrew

MA Si Hang, Frederick

ROBERTS, David

SETO Gin Chung, John

SHING Shin Cheung, Stewart

SO Wai Yin, Irene

SUN, Patrick

SZE Tsai Ping, Michael

TAI Tak Hing

TSANG Chi Suen, Trini

TSUI Yiu Wa, Alec

WONG Shiu Hoi, Peter

YEH V-Nee

YUE Wai Keung

The information set out in section 1 "Audited financial information for the year ended 30th June, 1999" (but excluding the unaudited statements of operations of the Futures Exchange for the periods of 6 months and 12 months ended 30th June, 1999) of this appendix III to this document has been extracted from the auditors' report and the special purpose accounts, including the notes to those accounts, of the Futures Exchange Group for the year ended 30th June, 1999 and uses the definitions contained therein.

The information relating to the Futures Exchange Group as at 30th June, 1999 or relating to periods ending on that date has been produced for the purposes of this document and does not represent a change to the normal 31st December financial year end of the Futures Exchange Group.

1. AUDITED FINANCIAL INFORMATION FOR THE YEAR ENDED 30TH JUNE 1999

AUDITORS' REPORT TO THE DIRECTORS OF HONG KONG FUTURES EXCHANGE LIMITED ("EXCHANGE") *(incorporated in Hong Kong with limited liability)*

We have audited the special purpose accounts set out on pages 114 to 128 which have been prepared on the basis set out in note 1 on page 117.

Respective responsibilities of directors and auditors

It is the responsibility of the directors to prepare special purpose accounts which give a true and fair view. In preparing special purpose accounts which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently.

It is our responsibility to form an independent opinion, based on our audit, on those special purpose accounts and to report our opinion to you.

Basis of opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the special purpose accounts and of whether the accounting policies are appropriate to the Exchange's and the Group'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 special purpose accounts are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the special purpose accounts. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion, the special purpose accounts which have been prepared on the basis set out in note 1 to the accounts, give a true and fair view, in all material respects, of the state of the Exchange's and the Group's affairs as at 30 June 1999 and of the Group's surplus and cash flows for the year then ended.

PricewaterhouseCoopers
Certified Public Accountants

Hong Kong, 5 August 1999

CONSOLIDATED STATEMENT OF OPERATIONS
FOR THE YEAR ENDED 30 JUNE 1999

	<i>Note</i>	<i>HK\$'000</i>
Turnover	3	<u>713,330</u>
Operating surplus before merger costs	4	184,059
Merger costs	4	<u>21,990</u>
Operating surplus before taxation		162,069
Taxation	5(a)	<u>6,651</u>
Operating surplus from ordinary activities	6, 16	<u>155,418</u>

BALANCE SHEETS
AS AT 30 JUNE 1999

	Note	Group HK\$'000	Exchange HK\$'000
Compensation fund deposits - net	8	—	—
Reserve fund net assets	9	388,272	—
Fixed assets	10	44,108	43,373
Investment in subsidiaries	11	—	1,000
Current assets			
Amounts due from subsidiaries	13	—	20,669
Accounts receivable, prepayments and deposits		66,640	28,520
Provisional profits tax paid	5(b)	11,844	1,313
Investment securities			
Margin clients	12	3,860,456	—
House	12	931,344	295,661
Margin fund deposits		1,557,478	—
Time deposits		29,737	29,737
Cash at bank		1,534	1,085
		<u>6,459,033</u>	<u>376,985</u>
Current liabilities			
Futures Exchange Clearing Members' margin deposits	14	5,417,934	—
Accounts payable and accruals		62,022	60,717
Amount payable to reserve fund		1,151	—
		<u>5,481,107</u>	<u>60,717</u>
Net current assets		<u>977,926</u>	<u>316,268</u>
		<u>1,410,306</u>	<u>360,641</u>
Financed by:			
Share capital	15	20,460	20,460
Share premium account		8,300	8,300
Retained surplus	16	950,644	289,251
Reserve fund	9	388,272	—
HKFE development fund	17	36,761	36,761
Total capital and reserves		1,404,437	354,772
Deferred taxation	5(c)	5,869	5,869
		<u>1,410,306</u>	<u>360,641</u>

CONSOLIDATED CASH FLOW STATEMENT FOR THE YEAR ENDED 30 JUNE 1999

	<i>Note</i>	<i>HK\$'000</i>
Net cash outflow from operating activities	18	(7,239,818)
Taxation		
Hong Kong profits tax paid		(39,404)
Tax rebates		2,832
		(36,572)
<i>Investing activities</i>		
Purchase of fixed assets		(42,129)
Sale of fixed assets		2
Purchase of investment securities		(4,978,088)
Proceeds on sale of investment securities		496,051
Interest earned by HKFE development fund		1,948
Net cash outflow from investing activities		(4,522,216)
Net cash outflow before financing		(11,798,606)
Financing		
Capital element of finance lease rental payments		(30)
Payment to reserve fund		(694)
Net cash outflow from financing		(724)
Decrease in cash and cash equivalents		(11,799,330)
Cash and cash equivalents at 1 July 1998		13,388,079
Cash and cash equivalents at 30 June 1999		1,588,749
Analysis of the balances of cash and cash equivalents		
Cash at bank		1,534
Time deposits		29,737
Margin fund deposits		1,557,478
		1,588,749

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

1 Basis of Preparation

These special purpose accounts ("accounts") have been prepared by the directors of Hong Kong Futures Exchange Limited ("Exchange") in order to comply with the Hong Kong Special Administrative Region Government's plans to merge the Exchange and the HKFE Clearing Corporation Limited ("HKCC") with the Stock Exchange of Hong Kong Limited and its associated Clearing Houses.

These accounts have been prepared for the period from 1 July 1998 to 30 June 1999. In addition to disclosing the audited Consolidated Statement of Operations for the year ended 30 June 1999, the audited Consolidated Statement of Operations for the six months ended 30 June 1999 has also been disclosed in note 23 to these accounts for information purposes. No supporting note disclosures have been made in respect of the six months Consolidated Statement of Operations.

No comparative information has been disclosed within these accounts. Other than in respect of this non-disclosure, these accounts have been prepared in accordance with generally accepted accounting principles in Hong Kong and with accounting standards issued by the Hong Kong Society of Accountants.

2 Principal accounting policies

(a) Basis of consolidation

The consolidated accounts include the results of the Exchange and its subsidiaries for the year ended 30 June 1999 and their balance sheets as at that date. All significant intercompany transactions and balances between the Exchange and its subsidiaries are eliminated on consolidation.

Investments in subsidiaries are stated at cost less provision, if necessary, for any permanent diminution in value. The results of subsidiaries are accounted for by the Exchange on the basis of dividends received and receivable.

(b) Revenue recognition

Interest income is recognised on a time apportionment basis, taking into account the principal amounts outstanding and interest rates applicable.

Revenue in respect of services rendered is recognised upon completion.

(c) Fixed assets

Fixed assets are stated at cost less accumulated depreciation.

Fixed assets are depreciated at rates sufficient to write off their cost over their estimated useful lives on a straight line basis and at the following annual rates:

Leasehold improvements	unexpired lease term
Furniture and equipment	33-1/3%
Computer systems	33-1/3 and 50%
Motor vehicles	33-1/3%
Air conditioning systems	unexpired lease term

Major costs incurred in restoring fixed assets to their normal working condition are recognised in the statement of operations. Improvements are capitalised and depreciated over their expected useful lives to the Exchange and its subsidiaries.

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

2 Principal accounting policies (cont'd)

The carrying amounts of fixed assets are reviewed regularly to assess whether their recoverable amounts have declined below their carrying amounts.

The gain or loss on disposal of a fixed asset is the difference between the net sales proceeds and the carrying amount of the relevant asset and is recognised in the statement of operations.

(d) *Assets held under lease*

Leases that substantially transfer to the Exchange all the rewards and risks of ownership of assets, other than legal title, are accounted for as finance leases. At the inception of a finance lease, the fair value of the asset is recorded together with the obligation, excluding the interest element, to pay future rentals.

Payments to the lessor are treated as consisting of capital and interest elements. Finance charges are charged to the statement of operations in proportion to the capital balances outstanding.

Assets held under finance leases are depreciated over the shorter of the lease term and their estimated useful lives as stated in note 2(c) above.

(e) *Investment securities*

Investment securities are comprised of investment grade debt securities and an investment in a professionally managed money market fund. The debt securities and money market fund investment are readily convertible into cash and are carried in the balance sheet as current assets. The liquidity of the investment securities is designed to mirror the Futures Exchange Clearing Members' margin deposits.

The investment securities are unlisted and stated at cost, less provision for any permanent diminution in value, on the basis that they are clearly identifiable and are intended by the Directors to be held on a continuing basis.

Profits or losses on realisation of investment securities are accounted for in the statement of operations as they arise and are included in gains on disposal of investment securities. Interest arising from investment securities is recognised in accordance with note 2(b).

(f) *Deferred taxation*

Deferred taxation is accounted for at the current taxation rate in respect of timing differences between profit as computed for taxation purposes and operating surplus as stated in the special purpose accounts to the extent that a liability or asset is expected to be payable or receivable in the foreseeable future.

(g) *Translation of foreign currencies*

Transactions in foreign currencies are translated at exchange rates ruling at the transaction dates. Monetary assets and liabilities expressed in foreign currencies are translated at rates of exchange ruling at the balance sheet date. Exchange differences arising in these cases are dealt with in the statement of operations.

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

3 Turnover and revenue

Turnover and revenue for the year comprise the following:—

	<i>HK\$'000</i>
Interest income	570,278
Transaction and clearing fees	136,586
Membership fees	4,199
Gain on disposal of investment securities	<u>2,267</u>
Turnover	<u>713,330</u>
Price reporting income	16,253
Accommodation charges	7,574
Net foreign exchange gain	1,382
Amount received from former clearing house	1,361
Sundry income	<u>6,250</u>
Total revenue	<u><u>746,150</u></u>

4 Operating surplus before taxation

The operating surplus before taxation for the year is stated after crediting and charging:—

	<i>HK\$'000</i>
<u>Crediting</u>	
Total revenue (<i>note 3</i>)	<u><u>746,150</u></u>
<u>Charging</u>	
Interest paid to Futures Exchange Clearing Members	296,894
Staff costs and related expenses	116,611
Depreciation	32,406
Merger costs (<i>note (a)</i>)	21,990
Legal and other professional fees	12,435
Loss on disposal of fixed assets	5,683
ATS migration — trading hall closure (<i>note (b)</i>)	3,601
Auditors' remuneration	<u>482</u>

(a) Certain costs arising in connection with the proposed merger with the Stock Exchange of Hong Kong Limited and its associated Clearing Houses (*note 21*).

(b) Certain trading hall closure costs in connection with the migration of HSI futures and HSI options from an "open outcry" system to electronic trading conducted on the Automated Trading System (*note 22*).

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

5 Taxation

- (a) Hong Kong profits tax has been provided at the rate of 16% on the estimated assessable profit for the year.

Taxation charged in the consolidated statement of operations for the year represents:—

	HK\$'000
Hong Kong profits tax	
— current year	8,763
— over provision in prior years	(918)
— deferred taxation	1,590
— tax rebates	(2,832)
Other Hong Kong taxation	<u>48</u>
	<u>6,651</u>

- (b) Provisional profits tax paid in the balance sheet represents:—

	Group HK\$'000	Exchange HK\$'000
Provision for Hong Kong profits tax	15,571	10,190
Payment of provisional profits tax for the year	(27,456)	(11,544)
Other Hong Kong taxation payable	<u>41</u>	<u>41</u>
	<u>(11,844)</u>	<u>(1,313)</u>

- (c) There are no significant unprovided deferred tax balances as at 30 June 1999.

6 Operating surplus from ordinary activities

The consolidated operating surplus from ordinary activities for the year was contributed as follows:—

	Group HK\$'000
Hong Kong Futures Exchange Limited	7,275
HKFE Clearing Corporation Limited	148,164
HKFE Clearing Linkage Limited	<u>(21)</u>
	<u>155,418</u>

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

7 Directors' emoluments

Exchange
HK\$'000

For management services	<u>7,500</u>
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No directors' emoluments were paid to the Chairman and non-executive directors of the Exchange during the year.

8 Compensation fund

The Exchange has made deposits of HK\$100,000 per shareholder amounting in aggregate to HK\$21,000,000 on behalf of its shareholders into a Compensation Fund established under the Commodities Trading (Amendment) Ordinance 1985 ("New Fund"). To the extent that they are not required to meet claims on the New Fund, the deposits are refundable when shareholders cease to be shareholders of the Exchange.

As at 30 June 1999 these deposits have been funded by shareholders to the extent of HK\$20,206,585 and by the Exchange to the extent of HK\$793,415. Deposits recovered, if contributed by shareholders, are refunded to them and if contributed by the Exchange are retained by the Exchange.

In view of the substantial value of claims paid out of the New Fund in prior years and the consequent contingent nature of the possible recovery of deposits, the Exchange has provided in full for deposits made by it to the New Fund which have not been recovered from shareholders. Any recoveries from shareholders are treated as sundry income in the year of actual recovery. Amounts totalling HK\$57,186 previously paid by the Exchange were recovered from shareholders during the year.

9 Reserve fund

The Reserve Fund was established to enable the Exchange's subsidiary, HKCC, to discharge its functions and is required to have, at all times, aggregate available funds of not less than HK\$200 million.

The Reserve Fund as at 30 June 1999 is comprised of the following:—

	Group HK\$'000
Futures Exchange Clearing Members' deposits	210,000
Interest income credited to the Reserve Fund	70,541
Former clearing house funds	
Appropriation from reserves of HKCC	77,408
Accrued interest	11,125
Appropriation from reserves of HKCC	<u>20,200</u>
	<u>389,274</u>
Less:	
Insurance premiums	(752)
Bank guarantee fees	<u>(250)</u>
	<u>388,272</u>
Insurance policies	120,000
Bank guarantees	50,000

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

9 Reserve fund (cont'd)

The investments included in the Reserve Fund are composed of debt securities and short term deposits and are represented as follows:

	<i>HK\$'000</i>
Debt securities	396,516
Short term deposits	<u>8,721</u>
	405,237
Less: net amounts payable	<u>16,965</u>
	<u><u>388,272</u></u>

The debt securities are comprised of investment grade paper with a Moody's credit rating of single A or higher and may be converted into cash within one trading day.

Both insurance policies and bank guarantees are renewed annually on 1 January. Commencing on 1 January 1999, insurance premiums and bank guarantee fees have been borne by the Reserve Fund.

In the event of a claim against HKCC which requires recourse to the Reserve Fund, the order of application of resources is as follows:—

- First - Appropriation from reserves of HKCC
- Second - Interest income credited to the Reserve Fund
- Third - Futures Exchange Clearing Members' deposits
- Fourth - Insurance policies
- Fifth - Former clearing house funds
- Sixth - Bank guarantees and facilities

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

10 Fixed assets

	Group					Total HK\$'000
	Leasehold improvements HK\$'000	Furniture and equipment HK\$'000	Computer systems HK\$'000	Motor vehicles HK\$'000	Air- conditioning systems HK\$'000	
Cost						
At 1 July 1998	22,851	11,786	91,048	1,066	3,048	129,799
Additions	9,602	6,760	23,868	—	1,899	42,129
Disposals	(12,885)	(2,422)	(647)	—	(40)	(15,994)
At 30 June 1999	19,568	16,124	114,269	1,066	4,907	155,934
Accumulated depreciation						
At 1 July 1998	8,516	6,253	73,019	660	1,281	89,729
Charge for the year	9,511	5,559	15,101	265	1,970	32,406
Disposals	(7,990)	(1,640)	(659)	—	(20)	(10,309)
At 30 June 1999	10,037	10,172	87,461	925	3,231	111,826
Net book value						
At 30 June 1999	9,531	5,952	26,808	141	1,676	44,108

Certain equipment is held under finance lease. At 30 June 1999, the cost and net book value of fixed assets held by the Group under finance leases amounted to HK\$407,700 and HK\$ Nil respectively.

	Exchange					Total HK\$'000
	Leasehold improvements HK\$'000	Furniture and equipment HK\$'000	Computer systems HK\$'000	Motor vehicles HK\$'000	Air- conditioning systems HK\$'000	
Cost						
At 1 July 1998	18,995	10,133	78,138	1,066	3,048	111,380
Additions	9,602	6,675	23,173	—	1,899	41,349
Disposals	(9,514)	(2,035)	(612)	—	(40)	(12,201)
At 30 June 1999	19,083	14,773	100,699	1,066	4,907	140,528
Accumulated depreciation						
At 1 July 1998	5,588	5,008	60,587	660	1,281	73,124
Charge for the year	9,192	5,223	14,525	265	1,970	31,175
Disposals	(5,195)	(1,318)	(611)	—	(20)	(7,144)
At 30 June 1999	9,585	8,913	74,501	925	3,231	97,155
Net book value						
At 30 June 1999	9,498	5,860	26,198	141	1,676	43,373

Certain equipment is held under finance lease. At 30 June 1999, the cost and net book value of fixed assets held by the Exchange under finance leases amounted to HK\$407,700 and HK\$ Nil respectively.

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

11 Investments in subsidiaries

	Exchange HK\$'000
Unlisted shares in subsidiaries, at cost	1,000

At 30 June 1999, the Exchange directly and indirectly held shares in the following subsidiaries:—

Name of subsidiary	Place of incorporation	Nominal value of issued ordinary shares HK\$	Interest held	Principal activities
<i>Direct holding:—</i>				
HKFE Clearing Corporation Limited	Hong Kong	1,000,000	100%	Clearing of and counterparty to all transactions entered into by Members of the Exchange
<i>Indirect holding:—</i>				
HKFE Clearing Linkage Limited	Hong Kong	2	100%	Dormant

12 Investment securities

(a) The carrying value of the investment securities are as follows:—

	Group HK\$'000	Exchange HK\$'000
Professionally managed debt securities portfolio	872,910	295,661
Money market fund	792,209	—
Debt securities	<u>3,126,681</u>	<u>—</u>
Total carrying value as at 30 June 1999	<u>4,791,800</u>	<u>295,661</u>

(b) At 30 June 1999, the market values of the investment securities are as follows:—

	Group Market value HK\$'000	Exchange Market value HK\$'000
Professionally managed debt securities portfolio	873,515	295,857
Money market fund	792,209	—
Debt securities	<u>3,115,707</u>	<u>—</u>

The professionally managed debt securities portfolio contains Hong Kong dollar debt securities with a Moody's credit rating of single A or higher.

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

12 Investment securities (cont'd)

The money market fund is a professionally managed mutual fund that invests in Certificates of Deposit, Floating Rate Notes and Commercial Paper. The Fund has a Moody's credit rating of Aaa.

The in-house debt securities portfolio is comprised of investment grade paper with a Moody's credit rating of single A or higher.

13 Amounts due from subsidiaries

	Exchange HK\$'000
Unsecured, interest-free and with no fixed terms of repayment	<u>20,669</u>

14 Futures Exchange Clearing members' margin deposits

These amounts represent the net balances due to the members of HKCC which are entitled in accordance with the rules and procedures of HKCC to register and clear with HKCC futures and options contracts traded on the Futures Exchange ("Futures Exchange Clearing Members") as at 30 June 1999 in respect of open contracts which will not crystallise until the settlement date. Any potential losses in respect of open contracts may be set off against the Futures Exchange Clearing Members' margin deposits, bank guarantees or the potential profit on other contracts.

In addition to the deposits, certain Futures Exchange Clearing Members have given bank guarantees in connection with temporary adjustments of their trading limits.

15 Share capital

	Exchange	
	Number of shares as at 30 June 1999	Balance as at 30 June 1999 HK\$'000
Authorised:		
Ordinary shares of HK\$100,000 each	641	64,100
Standard shares of HK\$25,000 each	36	900
Non-voting redeemable shares of HK\$10,000 each	500	<u>5,000</u>
		<u>70,000</u>
Issued and fully paid:		
Ordinary shares of HK\$100,000 each	196	19,600
Standard shares of HK\$25,000 each	34	850
Non-voting redeemable shares of HK\$10,000 each	1	<u>10</u>
		<u>20,460</u>

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

16 Retained surplus

	Group HK\$'000	Exchange HK\$'000
At 30 June 1998	807,861	293,250
Retained surplus after taxation for the year	155,418	7,275
Transfer to Reserve Fund of HKFE Clearing Corporation Limited	(1,361)	—
Transfer to HKFE development fund (note 17)	<u>(11,274)</u>	<u>(11,274)</u>
At 30 June 1999	<u>950,644</u>	<u>289,251</u>

17 HKFE development fund

The Fund was established on 1 July 1994 to support the development of Exchange products, markets and services, and to address the needs of the investing public. Included within the transaction and clearing fees, which are charged on each side of every trade conducted through the Exchange, is an amount of HK\$0.50 which is allocated to the Fund through appropriations from the retained surplus account. The Fund is used to support the costs of the above mentioned special development projects. Appropriation of the Fund requires the prior approval of the Securities and Futures Commission. No appropriation was made or applied during the year ended 30 June 1999.

	Group HK\$'000	Exchange HK\$'000
At 30 June 1998	23,539	23,539
Appropriation from operating surplus after taxation for the year (note 16)	11,274	11,274
Interest earned from bank deposits	1,041	1,041
Interest earned from investment securities	<u>907</u>	<u>907</u>
At 30 June 1999	<u>36,761</u>	<u>36,761</u>

18 Note to the cash flow statement

Reconciliation of operating surplus before taxation to net cash outflow from operating activities

	1999 HK\$'000
Operating surplus before taxation	162,069
Depreciation	32,406
Gains on disposal of investment securities	(2,267)
Loss on disposal of fixed assets	5,683
Decrease in accounts receivable, prepayments and deposits	27,734
Increase in accounts payable and accruals	38,616
Decrease in Futures Exchange Clearing Members' margin deposits	<u>(7,504,059)</u>
Net cash outflow from operating activities	<u>(7,239,818)</u>

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

19 Lease commitments

At 30 June 1999 the Group and the Exchange had commitments to make payments in the next twelve months under operating leases in respect of land and buildings which expire as follows:—

	Group HK\$'000	Exchange HK\$'000
Within one year	4,718	4,718
In the second to fifth years inclusive	<u>17,607</u>	<u>17,607</u>
	<u>22,325</u>	<u>22,325</u>

20 Capital commitments

	Group HK\$'000	Exchange HK\$'000
Authorised but not provided for:—		
Contracted	10,027	10,027
Not contracted	<u>14,145</u>	<u>14,145</u>
	<u>24,172</u>	<u>24,172</u>

Capital commitments as at 30 June 1999 primarily relate to hardware improvement and software enhancement for the Automated Trading System.

21 Merger of the Exchanges

On 3 March 1999, the Hong Kong Special Administrative Region Government announced plans to merge the Exchange and HKCC with the Stock Exchange of Hong Kong Limited and its associated Clearing Houses. The new entity will be demutualised and operate in the form of a listed commercial company. It is expected that the new entity will be listed in Hong Kong by September 2000. Costs associated with the merger, to the extent that they can be appropriately determined by the Directors, have been fully provided for at 30 June 1999.

22 Automated Trading System

As at the date of approval of the accounts the Board of Directors of the Exchange have decided to migrate the HSI futures and HSI options from an "open outcry" system to electronic trading conducted on the Automated Trading System. Subject to the satisfactory outcome of the test results, it is anticipated that the earliest possible date for the migration of HSI futures would be 16 August 1999. The migration of HSI options would follow shortly after this date in order to accommodate the necessary installation and testing of the option trading functionalities. Costs associated with the closure of the trading hall, to the extent that they can be appropriately determined by the Directors, have been fully provided for at 30 June 1999.

NOTES TO THE SPECIAL PURPOSE ACCOUNTS

- 23 Consolidated statement of operations for the six months ended 30 June 1999
(Extracted from the results for the year ended 30 June 1999)

	<i>HK\$'000</i>
Turnover	<u>260,186</u>
Operating surplus before merger costs	62,586
Merger costs	<u>21,990</u>
Operating surplus before taxation	40,596
Taxation credit	<u>(181)</u>
Operating surplus from ordinary activities	<u>40,777</u>

The above statement is extracted from the consolidated statement of operations for the year ended 30 June 1999 as set out on page 114 of the accounts. The audited consolidated statement of operations for the six months ended 30 June 1999 is included in the accounts for information purposes only. The statement has been prepared based on the accounting policies set out in note 2 to the accounts. Any changes to the accounting standards which came into effect for accounting periods commencing after 1 July 1998 have not been reflected in the above statement.

- 24 Approval of special purpose accounts

The special purpose accounts were approved by the board of directors of the Exchange on 5 August 1999.

UNAUDITED SUPPLEMENTARY INFORMATION
HONG KONG FUTURES EXCHANGE LIMITEDStatement of operations
For the year ended 30 June 1999

	<i>HK\$'000</i>
Turnover	<u>156,110</u>
Operating surplus before merger costs	34,487
Merger costs	<u>21,990</u>
Operating surplus before taxation	12,497
Taxation	<u>5,222</u>
Operating surplus from ordinary activities	<u>7,275</u>

UNAUDITED SUPPLEMENTARY INFORMATION
HONG KONG FUTURES EXCHANGE LIMITEDStatement of operations
For the six months ended 30 June 1999

	<i>HK\$'000</i>
Turnover	<u>75,720</u>
Operating surplus before merger costs	10,097
Merger costs	<u>21,990</u>
Operating surplus before taxation	(11,893)
Taxation	<u>875</u>
Operating deficiency from ordinary activities	<u>(12,768)</u>

The information set out in section 1 "Audited financial information for the year ended 30th June, 1999" and section 2 "Audited operating statement of the Guarantee Fund established by CCASS" of this appendix IV to this document has been extracted from auditors' report and audited accounts, including the notes to those accounts, of the HKSCC Group and the Guarantee Fund established under CCASS Rule 2501, respectively, for the year ended 30th June, 1999 and uses the definitions contained therein.

1. AUDITED FINANCIAL INFORMATION FOR THE YEAR ENDED 30TH JUNE, 1999

REPORT OF THE AUDITORS

Report of the Auditors to the Members of Hong Kong Securities Clearing Company Limited (incorporated in Hong Kong with limited liability)

We have audited the accounts on pages 133 to 161 which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective Responsibilities of Directors and Auditors

The Companies Ordinance requires the directors to prepare accounts which give a true and fair view. In preparing accounts 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 accounts and to report our opinion to you.

Basis of Opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the Company's and the Group'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 accounts are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the accounts. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion, the accounts give a true and fair view, in all material respects, of the state of affairs of the Company and of the Group as at 30 June 1999 and of the Group's surplus and cash flows for the year then ended and have been properly prepared in accordance with the Companies Ordinance.

KPMG
Certified Public Accountants

Hong Kong, 5 August 1999

CONSOLIDATED INCOME AND EXPENDITURE ACCOUNT

for the year ended 30 June 1999

Expressed in Hong Kong dollars

	Note	Group	
		1999 \$'000	1998 \$'000
Income			
Stock clearing and settlement fees		165,522	401,776
Depository, custody and nominee services fees		57,751	78,909
Registration and transfer fees on nominee services		115,480	191,571
Share registration services fees		9,873	19,665
Investor account services fees		1,905	114
Bank and other interest income		<u>90,710</u>	<u>86,824</u>
	3	<u>441,241</u>	<u>778,859</u>
Expenditure			
Staff expenses		156,288	155,270
Premises expenses		43,310	41,703
Promotion and publications		4,378	4,231
Maintenance and network expenses		29,854	24,952
Legal and professional fees		3,108	1,965
General administrative expenses		6,805	9,802
Financial expenses		6,256	7,420
Stock settlement expenses		6	—
Depository expenses		83	87
Share registration services expenses		44	1,328
Investor account services expenses		9	—
Project expenditure		11,574	4,436
Depreciation, amortisation and (profit)/loss on disposal of fixed assets		<u>48,723</u>	<u>103,133</u>
	4	<u>310,438</u>	<u>354,327</u>
Surplus before Taxation		130,803	424,532
Taxation credit/(charge)	8(a)	<u>837</u>	<u>(55,297)</u>
Surplus after Taxation		131,640	369,235
Retained surplus at the beginning of the year		<u>3,920</u>	<u>4,685</u>
Total available for appropriation		135,560	373,920
Transfers to			
General reserve		(80,000)	(200,000)
Reserve for capital infrastructure		—	(70,000)
Reserve for Guarantee Fund and risk management		—	(100,000)
Reserve for projects and development		<u>(50,000)</u>	<u>—</u>
Retained surplus at the end of the year	17(a)	<u>5,560</u>	<u>3,920</u>

APPENDIX IV
**FINANCIAL INFORMATION RELATING
TO THE HKSCC GROUP**
BALANCE SHEETS

at 30 June 1999

Expressed in Hong Kong dollars

	Note	Company		Group	
		1999 \$'000	1998 \$'000	1999 \$'000	1998 \$'000
Fixed Assets	9	<u>66,231</u>	<u>108,362</u>	<u>66,231</u>	<u>108,362</u>
Interest in Subsidiaries	10	<u>3,081</u>	<u>3,673</u>	<u>—</u>	<u>—</u>
Guarantee Fund	11	<u>200,000</u>	<u>200,000</u>	<u>200,000</u>	<u>200,000</u>
Current Assets					
Accounts receivable - participants	12	2,512,148	2,170,945	2,512,148	2,170,945
Shares bought-in and borrowed for CNS settlement	13	18,798	—	18,798	—
Deposits and prepayments		38,250	34,287	42,330	38,902
Cash at banks and in hand	14	<u>1,184,337</u>	<u>1,073,159</u>	<u>1,255,333</u>	<u>1,125,269</u>
		<u>3,753,533</u>	<u>3,278,391</u>	<u>3,828,609</u>	<u>3,335,116</u>
Current Liabilities					
Accounts payable - participants	12	2,608,350	2,219,325	2,608,350	2,219,325
Collateral received on shares bought-in and value of shares due to lenders	15	18,911	—	18,911	—
Amounts due to subsidiaries	10	15,844	6,840	—	—
Other payables and accruals		17,344	35,206	105,183	95,098
Provision for taxation	8(b)	<u>11,579</u>	<u>100,002</u>	<u>11,579</u>	<u>100,002</u>
		<u>2,672,028</u>	<u>2,361,373</u>	<u>2,744,023</u>	<u>2,414,425</u>
Net Current Assets		1,081,505	917,018	1,084,586	920,691
Non-Current Liabilities					
Deferred taxation liabilities	8(c)	6,357	12,933	6,357	12,933
Liabilities for participants' admission fees	16	<u>108,900</u>	<u>112,200</u>	<u>108,900</u>	<u>112,200</u>
		<u>1,235,560</u>	<u>1,103,920</u>	<u>1,235,560</u>	<u>1,103,920</u>
<i>Representing:</i>					
Income and Expenditure Account	17(a)	5,560	3,920	5,560	3,920
General Reserve	17(b)	380,000	300,000	380,000	300,000
Reserve for Capital Infrastructure	17(b)	450,000	450,000	450,000	450,000
Reserve for Guarantee Fund and Risk Management	17(b)	300,000	300,000	300,000	300,000
Reserve for Projects and Development	17(b)	<u>100,000</u>	<u>50,000</u>	<u>100,000</u>	<u>50,000</u>
		<u>1,235,560</u>	<u>1,103,920</u>	<u>1,235,560</u>	<u>1,103,920</u>

CONSOLIDATED CASH FLOW STATEMENT

for the year ended 30 June 1999

Expressed in Hong Kong dollars

	Note	Group	
		1999 \$'000	1998 \$'000
Net Cash Inflow from Operating Activities	19(b)	<u>158,613</u>	<u>108,218</u>
Returns on Investments and Servicing of Finance			
Interest received		86,411	72,525
Interest paid		<u>(5,001)</u>	<u>(7,188)</u>
Net cash inflow from returns on investments and servicing of finance		<u>81,410</u>	<u>65,337</u>
Taxation			
Hong Kong Profits Tax paid		(100,575)	(30,926)
10% refund on profits tax		<u>6,413</u>	<u>—</u>
Net cash outflow from taxation		<u>(94,162)</u>	<u>(30,926)</u>
Investing Activities			
Payments made for purchase of fixed assets		(12,519)	(46,895)
Proceeds from sales of fixed assets		22	234
Contribution to Guarantee Fund		—	(100,000)
Increase in deposits with banks maturing in 3 months or more when acquired		<u>(155,835)</u>	<u>(345,395)</u>
Net cash outflow from investing activities		<u>(168,332)</u>	<u>(492,056)</u>
Net cash outflow before financing		<u>(22,471)</u>	<u>(349,427)</u>
Financing			
Admission fees received from participants	16(b)	2,300	3,700
Admission fees refunded to participants	16(b)	<u>(5,600)</u>	<u>(1,250)</u>
Net cash (outflow)/inflow from financing		<u>(3,300)</u>	<u>2,450</u>
Decrease in Cash and Cash Equivalents		(25,771)	(346,977)
Cash and cash equivalents at the beginning of the year		<u>143,807</u>	<u>490,784</u>
Cash and cash equivalents at the end of the year	19(c)	<u>118,036</u>	<u>143,807</u>

NOTES ON THE ACCOUNTS

Expressed in Hong Kong dollars

1. Status of the Company*(a) Existing status*

The Company was incorporated in Hong Kong under the Companies Ordinance on 5 May 1989 and is limited by guarantee to the extent of \$50 million. The Company has since 28 May 1992 been declared by the Securities and Futures Commission (Commission) to be a recognised clearing house. The Securities and Futures (Clearing Houses) Ordinance (Ordinance), which governs the recognition of clearing houses, specifies that a recognised clearing house's rules and memorandum and articles of association and any changes thereto, unless otherwise exempted, have to be approved by the Commission. The Company shall also make or amend rules as may be requested by the Commission. Amendments to the Company's rules and constitution, where not exempted, are therefore subject to the approval of the Commission. In all other aspects, the Company conducts its business as a self-regulated organisation.

The Ordinance contains provisions which, for the main part, modify the application of the laws of insolvency to the extent necessary to provide protection for the operations of the central clearing and settlement functions of the Company. This protection is achieved through the Ordinance giving legal effect and certainty to the Company's default rules and default proceedings so that the rules and proceedings may prevail over some of the usual insolvency laws.

The Company owns and operates the Central Clearing And Settlement System (CCASS) for eligible securities listed on The Stock Exchange of Hong Kong Limited (Stock Exchange) and also owns and operates the other systems for its related depository, custody and nominee services. Unless otherwise isolated by the broker participants, all Stock Exchange trades in eligible securities are cleared and settled in CCASS on a continuous net settlement (CNS) basis and their settlement in CCASS is subject to the provisions of the Ordinance. Isolated Stock Exchange trades and other transactions in eligible securities are cleared and settled in CCASS on a trade-for-trade basis.

The Company has been designated an 'eligible foreign custodian' by the Securities and Exchange Commission of the United States of America and an 'approved depository' by The Securities and Futures Authority of the United Kingdom.

(b) Securities and Futures Market Reform

The Financial Secretary of The Government of the Hong Kong Special Administrative Region announced in his Budget speech on 3 March 1999 a market reform for the securities and futures markets. The reform includes fundamental changes in the market structure to be achieved through the demutualisation and merger of the five recognised and approved market operators in Hong Kong, namely The Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited, Hong Kong Securities Clearing Company Limited, The SEHK Options Clearing House Limited and HKFE Clearing Corporation Limited, into a single group with a new holding company, Hong Kong Exchanges and Clearing Limited (HKEC).

Upon successful completion of the merger, HKEC will become a commercial public holding company and the Exchanges and Clearing Houses will become its wholly-owned subsidiaries. Current members of the Exchanges will exchange their shares in the respective Exchanges for shares in HKEC based on the Exchanges' valuations and their relative attributable interests in HKEC. The Company will enhance the value of HKEC as a whole. However, as the Company is a company limited by guarantee which has no issued shares and shareholders, and under its constitution, none of the members of the Company has any right to receive any dividends nor to receive any distribution on a solvent liquidation of the Company, it is considered that the Company's members would not receive any allocation of shares in HKEC. Guarantee obligations of the Company's members under the Company's existing constitution will be relieved and replaced by any necessary arrangement by HKEC.

A comprehensive framework of checks and balances will be put in place to ensure that the commercial and public objectives of HKEC are properly balanced and that its clearing unit operates in a prudent manner taking risk management and infrastructure development as its prime objectives.

It is the target of the Government that voting by the members of the Exchanges to approve the demutualisation and merger will take place by September 1999, any necessary legislative enactments to give effect to the merger will be completed by March 2000 and listing of HKEC will be effected by September 2000.

At the end of the year, the Group had no commitments or expenditure authorised or contracted for the demutualisation and merger exercise and accordingly no provision has been made in these accounts in this regard.

2. Principal Accounting Policies

These accounts have been prepared in accordance with Statements of Standard Accounting Practice issued by the Hong Kong Society of Accountants, accounting principles generally accepted in Hong Kong and the requirements of the Hong Kong Companies Ordinance. A summary of the principal accounting policies adopted by the Group is set out below.

(a) Basis of Consolidation

The consolidated accounts include the audited accounts of the Company and all its subsidiary companies made up to 30 June each year. All material inter-company transactions are eliminated on consolidation.

(b) Recognition of Income

Fees for clearing and settlement of broker-to-broker trades in eligible securities transacted on the Stock Exchange are recognised in full on T+1, i.e. on the settlement day following the trade day, upon acceptance of the trades by the Company. Fees for settlement of other trades and transactions are recognised upon completion of the settlement. Custody fees for securities held in the CCASS Depository are calculated and accrued on a monthly basis. Surpluses on registration and transfer fees on nominee services are calculated and accrued on the book close dates of the relevant stocks during the financial year. Other fees are recognised when the Company renders the related services.

Service fees are stated in the Consolidated Income and Expenditure Account net of fee discounts which are granted by the Company from time to time.

Interest income is recognised on a time apportioned basis based on the principal amounts outstanding at the applicable rates of interest.

(c) Recognition of Receivables and Payables from/to Broker Participants on Stock Exchange Trades Settled under CNS

Upon acceptance of Stock Exchange trades for settlement in CCASS under CNS on a T+2 basis, the Company interposes itself between the broker participants as the settlement counterparty to the trades through novation. Final acceptance of such Stock Exchange trades is confirmed on T+1 by details contained in the final clearing statement transmitted by the Company to every broker participant.

The CNS money obligations due by/to broker participants on Stock Exchange trades which are confirmed and accepted on T+1 are thereafter recognised as receivables and payables on the Balance Sheets made up to such date and such later dates on which the said receivables and payables remain outstanding.

Money obligations relating to all other trades and transactions, for which the Company is merely providing a facility for their settlement within CCASS, are excluded from these accounts.

(d) Fixed Assets and Depreciation

Fixed assets are stated at cost less depreciation calculated to write off the costs of the assets on a straight line basis over the following anticipated useful lives:—

Leasehold improvements	The shorter of the period of the lease and the expected useful life to the Company
Mainframe and PC computer hardware and other software	3 years
Furniture and office equipment	5 years
Motor vehicles	4 years
Application software and development expenditure on completed projects	5 years

(e) Development Expenditure Capitalised

Development expenditure capitalised and recognised as a fixed asset in the Balance Sheets comprises all direct and allocated operating expenses attributable to development activities of distinct major projects approved by the Board and which would satisfy the following criteria:—

- (i) the project is technically and financially feasible for completion and use by the Group; and
- (ii) there is a demonstrated external demand for the services and facilities provided by the application of the completed project and its estimated future economic benefits or revenues would not be less than the carrying value of the development expenditure included under fixed assets in the Balance Sheets.

All operating and maintenance expenses incurred after the date of completion of the above projects as well as all expenses incurred on other non-qualifying projects and development activities are charged as expenses to the Consolidated Income and Expenditure Account in the period in which such expenses are incurred.

Amortisation of the cost of capitalised development expenditure is provided from the dates when the projects become operational.

(f) Deferred Taxation

Deferred taxation is calculated under the liability method in respect of the taxation effect arising from all timing differences which are expected with reasonable probability to crystallise in the foreseeable future.

(g) Translation of Foreign Currencies

Foreign currency transactions during the year are translated into Hong Kong dollars at the exchange rates ruling on the transaction dates. Foreign currency balances of monetary assets and liabilities at the balance sheet date are translated into Hong Kong dollars at the exchange rates ruling at such date; foreign currency balances of non-monetary assets and liabilities are translated at historical rates. Exchange gains and losses are dealt with in the Consolidated Income and Expenditure Account.

(h) *Staff Provident Fund*

The Group's contributions under the terms of the fund are charged to the Consolidated Income and Expenditure Account on an accruals basis. The assets of the fund are held separately from those of the Group and are independently administered. Forfeited employer's contributions arising upon employees leaving their employment prior to their full entitlement to the employer's contributions are retained in the reserve account of the fund and are not utilised to reduce the Group's existing contributions.

(i) *Guarantee Fund*

Under CCASS General Rule 2501, a Guarantee Fund has been established by way of contributions in cash and otherwise from broker participants. The Company has also made cash contributions to the Guarantee Fund for the purpose of providing additional resources to the Guarantee Fund. These accounts do not include the results, assets and liabilities of the Guarantee Fund, for which separate accounts have been prepared.

(j) *Operating Leases*

Leases where substantially all the rewards and risks of ownership of assets remain with the leasing company are accounted for as operating leases. Rentals applicable to such operating leases are charged to the Consolidated Income and Expenditure Account on a straight line basis over the lease term, except for rentals capitalised under Development Expenditure, which are accounted for in accordance with accounting policy 2(e).

(k) *Interest in subsidiaries*

The Company's interest in subsidiaries is stated at cost less provision for diminution in value as determined by the directors.

3. Turnover

Turnover represents the aggregate amount of service fees net of fee discounts to participants and interest income arising from the principal activities of the Group. Turnover for the year was \$441,241,000 (1998: \$778,859,000).

The Company may grant discounts on fees to participants from time to time. The category of fee ranking for discount, the amount of fee discount and the fee discount period are entirely within the discretion of the Board of Directors who may take the following factors into consideration:—

- (a) the level of current and future stock market turnover and utilisation of CCASS facilities;
- (b) the level of costs, development expenditure and commitments; and
- (c) the level of accumulated reserves and forecast operating results.

Details of income net of fee discounts and fee discounts are set out below. Fee discounts represent differences between the amount of fees based on their latest reduced rates for the financial year compared with the fees calculated at their respective original rates upon launch of CCASS or upon subsequent introduction of any new items of fees.

	Group			
	Income net of fee discounts		Fee discounts	
	1999	1998	1999	1998
	\$'000	\$'000	\$'000	\$'000
Stock clearing and settlement fees				
Stock Exchange trades	98,743	250,573	201,728	359,737
Settlement Instructions	62,370	148,859	159,832	208,050
Option trades and option SIs	287	491	1,814	765
Default fee on T+2 unsettled positions	2,337	—	—	—
Other revenues	1,785	1,853	2,464	1,787
	<u>165,522</u>	<u>401,776</u>	<u>365,838</u>	<u>570,339</u>
Depository, custody and nominee services fees				
Stock withdrawal fees	7,340	19,173	3,665	9,605
Stock custody fees	24,106	24,465	10,071	9,323
Dividend and interest collection fees	14,818	21,454	19,268	23,743
Corporate actions service fees	8,573	8,417	13,697	6,364
Supply of participants' shareholding reports service fee and others	2,914	5,400	1	1
	<u>57,751</u>	<u>78,909</u>	<u>46,702</u>	<u>49,036</u>
Registration and transfer fees on nominee services	<u>115,480</u>	<u>191,571</u>	<u>60,195</u>	<u>45,922</u>
Share registration services fees				
Flotation services fees	275	7,036	—	—
Monthly retainer fees, scrip fees and others	9,598	12,629	—	—
	<u>9,873</u>	<u>19,665</u>	<u>—</u>	<u>—</u>
Investor account services fees				
Settlement Instructions clearing and settlement fees	156	15	21	19
Stock withdrawal fees	164	—	—	—
Stock custody fees	448	24	—	—
Dividend and interest collection fees	101	3	—	—
Corporate actions service fees and others	56	2	—	—
Registration and transfer fees on nominee services	980	70	178	—
	<u>1,905</u>	<u>114</u>	<u>199</u>	<u>19</u>
Bank and other interest income				
Interest on CCASS participants' cash collateral	6,132	12,761	—	—
Interest on the Group's retained surplus and reserves	84,578	74,063	—	—
	<u>90,710</u>	<u>86,824</u>	<u>—</u>	<u>—</u>
	<u>441,241</u>	<u>778,859</u>	<u>472,934</u>	<u>665,316</u>

4. Operating Expenses

	Group	
	1999	1998
	\$'000	\$'000
Staff Expenses		
Salaries and allowances	124,269	123,598
Provident fund - employer's contributions	13,377	12,197
Staff welfare and training	14,636	14,662
Group medical and life insurance	3,760	3,442
Staff recruitment	246	1,371
	<u>156,288</u>	<u>155,270</u>
Premises Expenses		
Rents, rates and building management fees	35,755	34,183
Air-conditioning, electricity, telephone, fax, security and others	7,555	7,520
	<u>43,310</u>	<u>41,703</u>
Promotion and Publications		
Promotion, advertising and entertaining	2,119	1,559
Publications	2,259	2,672
	<u>4,378</u>	<u>4,231</u>
Maintenance and Network Expenses		
Mainframe hardware and software rental and maintenance	16,622	14,880
Year 2000 compliance expenditure	4,306	460
Other repairs and maintenance	4,104	5,149
Network rental	4,822	4,463
	<u>29,854</u>	<u>24,952</u>
Legal and Professional Fees		
Legal fees	1,408	647
Auditors' remuneration	437	405
Accounting and tax fees	181	37
Consultancy, survey and others	1,082	876
	<u>3,108</u>	<u>1,965</u>
General Administrative Expenses		
Postage, printing, stationery and computer supplies	2,233	3,797
Insurance	2,450	3,571
Travelling - local and overseas	601	697
Other	1,521	1,737
	<u>6,805</u>	<u>9,802</u>

		Group	
		1999	1998
		\$'000	\$'000
Financial Expenses			
Bank charges		1,260	257
Exchange differences		2	1
Bank overdraft interest		—	5
Interest on CCASS participants' cash collateral	4(b)	<u>4,994</u>	<u>7,157</u>
		<u>6,256</u>	<u>7,420</u>
Stock Settlement Expenses			
Stock borrowing fees on T+2 unsettled positions		<u>6</u>	<u>—</u>
Depository Expenses			
Stamp duty on transfer deeds and sundries		<u>83</u>	<u>87</u>
Share Registration Services Expenses			
Wages and allowances		17	1,090
Staff recruitment		—	27
Printing and stationery		27	112
Rental of facilities		—	93
Other direct expenses		<u>—</u>	<u>6</u>
	4(c)	<u>44</u>	<u>1,328</u>
Investor Account Services Expenses			
Other direct expenses		<u>9</u>	<u>—</u>
Project Expenditure			
Corporate communication project		—	961
Realtime delivery versus payment project		—	1,945
Stock borrowing and lending project	4(d)	5,607	1,530
Electronic initial public offerings project	4(d)	2,013	—
Exchange fund notes project	4(d)	1,363	—
Growth enterprise market stock project	4(d)	<u>2,591</u>	<u>—</u>
		<u>11,574</u>	<u>4,436</u>
Depreciation and Amortisation			
Depreciation and amortisation of fixed assets		48,568	103,308
Loss/(profit) on disposal of fixed assets		<u>155</u>	<u>(175)</u>
		<u>48,723</u>	<u>103,133</u>
Total		<u><u>310,438</u></u>	<u><u>354,327</u></u>

- (a) The above total included charges for operating lease rentals payable in respect of land and buildings of \$35,597,000 (1998: \$33,591,000), computer hardware and software of \$960,000 (1998: \$2,537,000) and equipment of \$nil (1998: \$395,000), which have been charged to various expense accounts in accordance with the above classification of operating expenses.

- (b) Decrease in interest expense on CCASS participants' cash collateral was due to decrease in interest paid to broker participants resulting from the decrease in marks collected in cash from them on a daily basis in accordance with the Company's risk management measures. Decrease in marks collected reflected the decrease in stock market turnover and volatility during the financial year. There was a corresponding decrease in interest income earned by the Company on CCASS participants' cash collateral during the financial year.
- (c) Share registration services expenses represent wages, consumables, equipment rentals and other costs specifically incurred in providing services on initial public offerings handled by a subsidiary, HKSCC Registrars Limited, during the financial year.
- (d) Project Expenditure

Expenditure specifically incurred during the financial year for the development of minor projects not capitalised but charged as expenses to the Consolidated Income and Expenditure Account was as follows:—

	Stock borrowing and lending project 1999 \$'000	Electronic initial public offerings project 1999 \$'000	Exchange fund notes project 1999 \$'000	Growth enterprise market stock project 1999 \$'000	Total 1999 \$'000	Total 1998 \$'000
Staff Expenses						
Salaries and Wages	5,225	1,946	1,300	2,591	11,062	4,149
Provident Fund						
— employer's contributions	—	—	—	—	—	21
Recruitment	91	—	—	—	91	103
	<u>5,316</u>	<u>1,946</u>	<u>1,300</u>	<u>2,591</u>	<u>11,153</u>	<u>4,273</u>
Promotion and Publications						
Promotion and advertising	—	23	—	—	23	—
Publications	—	—	—	—	—	31
	<u>—</u>	<u>23</u>	<u>—</u>	<u>—</u>	<u>23</u>	<u>31</u>
Maintenance and Network Expenses						
Mainframe software maintenance	—	—	20	—	20	—
Other repairs and maintenance	—	—	3	—	3	4
Network rental	—	—	12	—	12	38
	<u>—</u>	<u>—</u>	<u>35</u>	<u>—</u>	<u>35</u>	<u>42</u>
Legal and Professional Fees						
Legal fees	281	—	23	—	304	83
Consultancy, survey and others	10	44	—	—	54	—
	<u>291</u>	<u>44</u>	<u>23</u>	<u>—</u>	<u>358</u>	<u>83</u>
General Administrative Expenses						
Printing, stationery and computer suppliers	—	—	5	—	5	4
Other	—	—	—	—	—	3
	<u>—</u>	<u>—</u>	<u>5</u>	<u>—</u>	<u>5</u>	<u>7</u>
	<u>5,607</u>	<u>2,013</u>	<u>1,363</u>	<u>2,591</u>	<u>11,574</u>	<u>4,436</u>

5. Directors' Remuneration

Directors' remuneration disclosed pursuant to Section 161 of the Companies Ordinance is as follows:—

	Group	
	1999 \$'000	1998 \$'000
Fees	—	—
Salaries	4,320	4,217
Performance award	<u>325</u>	<u>320</u>
	<u>4,645</u>	<u>4,537</u>

The above remuneration was attributable to the Chief Executive of the Company. No remuneration was paid or is payable to the Chairman or other directors of the Company.

6. Remuneration of Other Executive Staff

The six highest paid employees in the Group included one director (1998: one) whose remuneration is set out in note 5. The remuneration of the other five (1998: five) employees was as follows:—

	Group	
	1999 \$'000	1998 \$'000
Salaries	10,600	10,098
Performance award	703	863
Increase in entitlement during the year to the <i>employer's contributions to staff provident fund</i> which were made in the past and current years	<u>3,023</u>	<u>1,511</u>
	<u>14,326</u>	<u>12,472</u>

The remuneration of these employees was in the following ranges:—

	Group	
	1999 Number of employees	1998 Number of employees
\$1,500,001 - \$2,000,000	—	1
\$2,000,001 - \$2,500,000	1	2
\$2,500,001 - \$3,000,000	2	1
\$3,000,001 - \$3,500,000	1	1
\$3,500,001 - \$4,000,000	1	—

Remuneration included the payment of performance award to staff during the year. The performance award was in recognition of the effort and contribution of the staff on CCASS operations and for the project development work. The performance award payment was at the discretion of the Company and was considered on an ad-hoc basis.

7. Staff Provident Fund

The Group operates a defined contribution provident fund for all eligible permanent staff. The assets of the fund are held separately from those of the Group and are independently administered. Eligible staff may elect to join the fund and contribute either 0%, 2.5% or 5% of their salaries to the fund, against which the Group will contribute 5%, 10% or 12.5% respectively. Staff will not become entitled to the employer's contributions if they are dismissed or serve for less than three years of service after joining the fund. Staff are entitled to 0.3 (i.e. 30%) of the employer's contributions together with interest thereon upon completion of three years of service with the Group after joining the fund. The ranking factor of 0.3 will be increased by 0.1 for each subsequent completed year of service, with full entitlement upon completion of ten years of service after joining the fund. Full entitlement for less than ten years of service will also be granted on normal retirement at age 60, permanent disability or death of the staff member. The provident fund charge for the year represents contributions payable by the Group to the fund which amounted to \$13,377,000 (1998: \$12,218,000). Employer's contributions forfeited during the year and not utilised by the Group for setting off the aforesaid contributions but retained in the reserve account of the fund amounted to \$952,000 (1998: \$2,491,000). Reserves of the fund representing forfeited employer's contributions are available for distribution to the fund members at the discretion of the trustees of the fund.

8. Taxation

(a) Taxation credit/(charge) in the Consolidated Income and Expenditure Account represents:—

	Group	
	1999 \$'000	1998 \$'000
Provision for Hong Kong profits tax for the year	(12,193)	(61,587)
Overprovision of Hong Kong profits tax in prior years	41	2
Transfer from deferred taxation	<u>6,576</u>	<u>6,288</u>
	(5,576)	(55,297)
10% refund of profits tax paid in respect of the accounting year ended 30 June 1997	<u>6,413</u>	<u>—</u>
	<u>837</u>	<u>(55,297)</u>

Hong Kong profits tax has been provided for at 16% (1998:16%) on the estimated assessable profits for the year.

(b) Provision for taxation liabilities in the Balance Sheets represents:—

	Company and Group	
	1999 \$'000	1998 \$'000
Provision for Hong Kong profits tax in respect of prior years	100,002	69,343
Payments of Profits Tax and Provisional Profits Tax in respect of prior years	(100,575)	(30,926)
Overprovision transferred to Income and Expenditure Account	<u>(41)</u>	<u>(2)</u>
Estimated tax (receivable)/payable relating to prior years	(614)	38,415
Provision for Hong Kong profits tax for the year	<u>12,193</u>	<u>61,587</u>
	<u>11,579</u>	<u>100,002</u>

(c) Deferred taxation liabilities in the Balance Sheets represent:—

	Company and Group	
	1999	1998
	\$'000	\$'000
Balance at the beginning of the year	12,933	19,221
Transfer to Income and Expenditure Account	(6,576)	(6,288)
Balance at the end of the year	<u>6,357</u>	<u>12,933</u>

There is no significant deferred tax liability not provided for at 30 June 1999. The major components of deferred tax liabilities at 30 June 1999 were:—

	Company and Group	
	1999	1998
	\$'000	\$'000
Accelerated depreciation allowances	3,809	9,342
Accelerated tax allowances on development expenditure	<u>2,548</u>	<u>3,591</u>
Balance at the end of the year	<u>6,357</u>	<u>12,933</u>

9. Fixed Assets

Company and Group	Leasehold improvements	Computer hardware	Computer software	Furniture, equipment & vehicles	Application software & development expenditure	Total
					on completed projects	
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
Cost						
At 30 June 1998	61,441	99,014	32,911	25,857	353,483	572,706
Additions	644	2,323	1,921	1,726	—	6,614
Disposals	<u>(1,087)</u>	<u>(1,869)</u>	<u>(387)</u>	<u>(933)</u>	—	<u>(4,276)</u>
At 30 June 1999	<u>60,998</u>	<u>99,468</u>	<u>34,445</u>	<u>26,650</u>	<u>353,483</u>	<u>575,044</u>
Depreciation						
At 30 June 1998	42,029	62,766	25,569	17,340	316,640	464,344
Charge for the year	10,844	17,767	3,505	4,178	12,274	48,568
Written back on disposals	<u>(1,086)</u>	<u>(1,847)</u>	<u>(387)</u>	<u>(779)</u>	—	<u>(4,099)</u>
At 30 June 1999	<u>51,787</u>	<u>78,686</u>	<u>28,687</u>	<u>20,739</u>	<u>328,914</u>	<u>508,813</u>
Net Book Value						
At 30 June 1999	<u>9,211</u>	<u>20,782</u>	<u>5,758</u>	<u>5,911</u>	<u>24,569</u>	<u>66,231</u>
At 30 June 1998	<u>19,412</u>	<u>36,248</u>	<u>7,342</u>	<u>8,517</u>	<u>36,843</u>	<u>108,362</u>

The components of "Application software & development expenditure on completed projects" at 30 June 1999 were as follows:—

	Application software \$'000	Development expenditure capitalised \$'000	Total of completed projects \$'000
Cost			
CCASS	43,325	248,789	292,114
Depository project	28,800	19,374	48,174
Investor Participation project	—	13,195	13,195
	<u>72,125</u>	<u>281,358</u>	<u>353,483</u>
At 30 June 1999			
Depreciation and amortisation			
CCASS	43,325	248,789	292,114
Depository project	20,160	13,562	33,722
Investor Participation project	—	3,078	3,078
	<u>63,485</u>	<u>265,429</u>	<u>328,914</u>
At 30 June 1999			
Book Value			
CCASS	—	—	—
Depository project	8,640	5,812	14,452
Investor Participation project	—	10,117	10,117
	<u>8,640</u>	<u>15,929</u>	<u>24,569</u>
At 30 June 1999			

10. Interest in Subsidiaries

	Company	
	1999	1998
	\$	\$
Unlisted shares at cost	40	240
Amounts due from a subsidiary	7,974,400	8,207,562
	<u>7,974,440</u>	<u>8,207,802</u>
Less: Aggregate provision for diminution in value of HKSCC Registrars Limited	<u>(4,893,000)</u>	<u>(4,535,000)</u>
	<u>3,081,440</u>	<u>3,672,802</u>
Amounts due to subsidiaries		
— amounts collected in advance on behalf of HKSCC Nominees Limited as the common nominee for conversion and subscription of stock warrants and rights on behalf of participants	(3,387,780)	—
— other amounts	(12,455,873)	(6,839,595)
	<u>(15,843,653)</u>	<u>(6,839,595)</u>
	<u>(12,762,213)</u>	<u>(3,166,793)</u>

Details of the subsidiary companies, which are incorporated in Hong Kong, are as follows:—

Name of Company	Percentage and class of shares held by the Company	Principal activity
HKSCC Nominees Limited	100% ordinary	Acting as common nominee in respect of securities held in the CCASS Depository
HKSCC Registrars Limited	100% ordinary	Acting as share registrar of companies listed in Hong Kong

11. Guarantee Fund

The Company has contributed a cumulative total of \$200 million at 30 June 1999 (1998: \$200 million) in cash to provide additional resources to the CCASS Guarantee Fund. The contribution is administered by the Risk Management Committee of the Company. Contributions will be recoverable by the Company when the Risk Management Committee considers that they are in excess of the total resources required by the CCASS Guarantee Fund. In accordance with the Terms of Reference of the Risk Management Committee laid down by the Board of Directors, the Risk Management Committee exercises all the powers and functions of the Board of Directors on all matters concerning risk management under CCASS including the administration of the Fund and the investment of the Fund's assets, according to the rules and policies laid down by the Board of Directors.

12. Accounts Receivable from, and Payable to, Participants

	Company and Group	
	1999 \$'000	1998 \$'000
Receivable from Participants		
CNS money obligations	2,506,829	2,166,667
CCASS fees	5,319	4,278
	<u>2,512,148</u>	<u>2,170,945</u>
Payable to Participants		
CNS money obligations	2,513,278	2,169,088
Marks collected	84,502	44,294
Cash margins received	8,353	5,334
Deposits received on investor accounts, refundable after 3 months upon closing of an investor account	2,217	609
	<u>2,608,350</u>	<u>2,219,325</u>

13. Shares Bought-in and Borrowed for CNS Settlement

	Company and Group	
	1999	1998
	\$'000	\$'000
Shares in hand at cost, representing buy-ins on T+3 by the Company against unsettled CNS short positions. Shares were on hold for delivery to the short brokers pending confirmation of good payment by them on 2 July 1999 (refer note 15)	13,750	—
Shares at market value due and receivable from CNS short positions which in the meantime had been borrowed by the Company for delivery to CNS long positions (refer note 15)	5,048	—
	<u>18,798</u>	<u>—</u>

14. Cash at Banks and in Hand

	Company		Group	
	1999	1998	1999	1998
	\$'000	\$'000	\$'000	\$'000
Deposits with banks maturing within 3 months when acquired	—	33,360	6,200	82,996
Current and savings bank account balances	<u>107,040</u>	<u>58,337</u>	<u>111,836</u>	<u>60,811</u>
Cash and cash equivalents	107,040	91,697	118,036	143,807
Deposits with banks maturing in 3 months or more when acquired	<u>1,077,297</u>	<u>981,462</u>	<u>1,137,297</u>	<u>981,462</u>
Cash at banks and in hand	<u>1,184,337</u>	<u>1,073,159</u>	<u>1,255,333</u>	<u>1,125,269</u>

15. Collateral Received on Shares Bought-in and Value of Shares Due to Lenders

	Company and Group	
	1999	1998
	\$'000	\$'000
Payments by short brokers for buy-in of shares executed by the Company in respect of:—		
shares on-hold by the Company (refer note 13)	13,750	—
shares pending receipt by the Company	113	—
Shares at market value due to lenders to be unwound by the Company by shares receivable from CNS short positions (refer note 13)	<u>5,048</u>	<u>—</u>
	<u>18,911</u>	<u>—</u>

16. Liabilities for Participants' Admission Fees

CCASS General Rule 303 provides that every CCASS participant other than an investor participant shall pay an admission fee and sign a participant agreement with the Company. The purpose of the admission fee is to finance the development costs of CCASS and to reduce the loan interest burden of the Company, the effect of which has been taken into account in determining the CCASS tariff structure. The Company has prescribed that the admission fee for broker participants is \$50,000 for every 'A' share held by the participant in the Stock Exchange; the admission fee for custodian and clearing agency participants is \$1,000,000 each; and for stock pledgee participants, the fee is \$200,000 each. The admission fees are non-interest bearing and are repayable upon the expiry of seven years from the date of admission of the participant or upon the termination of the participant's participation in CCASS, whichever is later. The Company at its discretion has granted early refunds of admission fees to terminated participants after six months from the date of termination of their participation in CCASS and to broker participants after six months from the date of sale of their Stock Exchange 'A' shares.

	Company and Group	
	1999	1998
	\$'000	\$'000
(a) Admission fees outstanding at the end of the year represent admission fees collected from:—		
489 (1998: 502) broker participants holding 646 (1998: 875) 'A' shares in the Stock Exchange	42,300	43,750
61 (1998: 63) custodian participants	61,000	63,000
1 (1998: 1) clearing agency participant	1,000	1,000
7 (1998: 8) stock pledgee participants	<u>1,400</u>	<u>1,600</u>
	105,700	109,350
25 (1998: 18) terminated broker participants previously holding 40 (1998: 37) 'A' shares in the Stock Exchange	2,000	1,850
1 (1998: 1) terminated custodian participant	1,000	1,000
1 (1998: nil) terminated stock pledgee participant	<u>200</u>	<u>—</u>
	<u>108,900</u>	<u>112,200</u>
(b) Movements in admission fees during the year were as follows:—		
At the beginning of the year	112,200	109,750
Admission fees collected during the year	2,300	3,700
Admission fees refunded during the year	<u>(5,600)</u>	<u>(1,250)</u>
At the end of the year	<u>108,900</u>	<u>112,200</u>

17. Retained Surplus and Reserves

		Company and Group	
		1999	1998
		\$'000	\$'000
(a)	<i>Income and Expenditure Account</i>		
	Retained surplus at the beginning of the year	3,920	4,685
	Surplus after taxation (i)	131,640	369,235
	Transfer to general reserve	(80,000)	(200,000)
	Transfer to reserve for capital infrastructure	—	(70,000)
	Transfer to reserve for Guarantee Fund and risk management	—	(100,000)
	Transfer to reserve for projects and development	<u>(50,000)</u>	<u>—</u>
	Retained surplus at the end of the year (ii)	<u>5,560</u>	<u>3,920</u>
(i)	Surplus after taxation for the year dealt with in the accounts of:—		
	the Company	131,640	369,235
	the subsidiaries - (deficit)/surplus	(358)	7,798
	Consolidation adjustment for provision for diminution in value of HKSCC Registrars Limited made in the Company's Income and Expenditure Account	<u>358</u>	<u>(7,798)</u>
		<u>131,640</u>	<u>369,235</u>
(ii)	Surplus at the end of the year retained in:—		
	the Company	5,560	3,920
	the subsidiaries - deficit	(4,893)	(4,535)
	Consolidation adjustment	<u>4,893</u>	<u>4,535</u>
		<u>5,560</u>	<u>3,920</u>

(b) *Movement in Reserves*

Company and Group	At the beginning of the year		Transfers from Income and Expenditure Account		At the end of the year	
	1999	1998	1999	1998	1999	1998
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
General reserve	300,000	100,000	80,000	200,000	380,000	300,000
Reserve for capital infrastructure	450,000	380,000	—	70,000	450,000	450,000
Reserve for Guarantee Fund and risk management	300,000	200,000	—	100,000	300,000	300,000
Reserve for projects and development	50,000	50,000	50,000	—	100,000	50,000
	<u>1,100,000</u>	<u>730,000</u>	<u>130,000</u>	<u>370,000</u>	<u>1,230,000</u>	<u>1,100,000</u>

(c) *Nature and purpose of Reserves*

Four reserves have been set up by the Company by transfers from retained surplus as determined by the directors from time to time for the following purposes:—

(i) *General Reserve*

This represents the amount of retained surplus set aside and available for making good any future temporary operating deficit in the Income and Expenditure Account as a result of shrinkage in stock market turnover before having to revert to increases in CCASS tariffs and for other contingencies.

(ii) *Reserve for capital infrastructure*

This represents the amount of retained surplus set aside as capital base of the Company in respect of investment in fixed assets other than projects under development.

(iii) *Reserve for Guarantee Fund and risk management*

This represents the amount of retained surplus set aside by the Company for providing additional resources to the CCASS Guarantee Fund and for general risk management purposes in support of CCASS and depository operations.

(iv) *Reserve for projects and development*

This represents the amount of retained surplus set aside in respect of any major projects and development undertaken by the Company and for providing resources for future prospective projects and development.

18. Collateral Received and Securities Unclaimed and under Lien and Custody

(a) Collateral Received from Participants

	Company and Group	
	1999	1998
	<i>\$'000</i>	<i>\$'000</i>
Collateral provided by broker participants in the form of bank guarantees in favour of the Company not included in the Balance Sheets of the Company and the Group	<u>2,629,420</u>	<u>703,460</u>

(b) Securities Unclaimed and under Lien

	Group	
	1999	1998
	<i>\$'000</i>	<i>\$'000</i>
Securities unclaimed and under lien at market value held by the Group not included in the Balance Sheet of the Group	<u>14,924</u>	<u>9,065</u>

(c) Securities under Custody

	Group	
	1999	1998
	<i>\$Million</i>	<i>\$Million</i>
Securities at market value held by the Group in the CCASS Depository under custody on behalf of the participants not included in the Balance Sheet of the Group	<u>1,103,360</u>	<u>664,414</u>

19. Cash Flow Statement Analysis

(a) Cash and Cash Equivalents in Cash Flow Statement

Cash is defined as cash in hand and deposits repayable on demand with any bank or other financial institution. Cash equivalents are defined as short-term highly liquid investments which are readily convertible into known amounts of cash without notice and which were within three months of maturity when acquired; less advances from banks repayable within three months from the date of the advance. Cash flow is defined as an increase or decrease in cash or cash equivalents resulting from a transaction.

	Group	
	1999	1998
	\$'000	\$'000
(b) Reconciliation of Surplus before Taxation to Net Cash Inflow from Operating Activities		
Surplus before taxation for the year	130,803	424,532
Interest income	(90,710)	(86,824)
Interest expenses	4,994	7,162
Depreciation and amortisation	48,568	103,308
Loss/(profit) on disposal of fixed assets	155	(175)
(Increase)/decrease in receivables from participants, shares bought-in and borrowed for CNS settlement and deposits and prepayments	(359,130)	1,434,028
Increase/(decrease) in payables to participants, collateral received on shares bought-in and value of shares due to lenders and other payables and accruals	<u>423,933</u>	<u>(1,773,813)</u>
Net cash inflow from operating activities for the year	<u>158,613</u>	<u>108,218</u>
(c) Analysis of Balances of Cash and Cash Equivalents		
Deposits with banks maturing within 3 months when acquired	6,200	82,996
Cash at banks and in hand	<u>111,836</u>	<u>60,811</u>
Cash and cash equivalents at the end of the year	<u>118,036</u>	<u>143,807</u>

20. Related Party Transactions Expressed in Hong Kong dollars

For the purpose of these accounts, parties are considered to be related to the Group if the parties have the ability, directly or indirectly, to control the Group or exercise significant influence over the Group in making financial and operating decisions, or vice versa, or where the Group and the parties are subject to common control or common significant influence. Related parties may be individuals or other entities.

During the year, the Group had the following material transactions with the six members of the Company, which were undertaken on normal commercial terms in the ordinary course of business:—

	Group	
	1999 \$'000	1998 \$'000
(a) With The Stock Exchange of Hong Kong Limited		
Charges for the use of conference room facilities	288	288
Charges for the administration of staff provident fund scheme	134	101
Charges for simultaneous interpretation and other services	476	364
Agency service fee income for supervision of physical settlement of Stock Exchange trades	<u>(1)</u>	<u>(2)</u>
Charges payable by the Group for the year	<u>897</u>	<u>751</u>
(b) With The Hongkong and Shanghai Banking Corporation Limited		
Bank charges on CCASS electronic money settlement	2,523	2,872
Bank overdraft interest	—	5
Bank overdraft commitment fee and sundry bank charges	130	19
Staff medical and dental insurance premium	<u>3,206</u>	<u>3,025</u>
Charges payable by the Group for the year	<u>5,859</u>	<u>5,921</u>
Bank interest income earned by the Group for the year	<u>(20,971)</u>	<u>(56)</u>
Bank interest income derived by the Group on unclaimed dividends for the year	<u>(4,203)</u>	<u>(2,629)</u>
Bank balances at 30 June - Group	<u>111,001</u>	<u>59,429</u>
Bank deposits at 30 June - Group	<u>247,700</u>	<u>49,636</u>
(c) With Bank of China		
Bank charges	<u>—</u>	<u>1</u>
Bank interest income earned by the Group for the year	<u>(23,974)</u>	<u>(34,466)</u>
Bank balances at 30 June - Group	<u>4</u>	<u>3</u>
Bank deposits at 30 June - Group	<u>260,240</u>	<u>405,741</u>
(d) With The Bank of East Asia, Limited		
Bank overdraft commitment fee and sundry bank charges	<u>13</u>	<u>13</u>
Bank interest income earned by the Group for the year	<u>(11,505)</u>	<u>(18,449)</u>
Bank balances at 30 June - Group	<u>14</u>	<u>6</u>
Bank deposits at 30 June - Group	<u>38,556</u>	<u>237,866</u>

	Group	
	1999 \$'000	1998 \$'000
(e) With Hang Seng Bank Limited		
Bank overdraft commitment fee and sundry bank charges	<u>54</u>	<u>57</u>
Bank interest income earned by the Group for the year	<u>(9,474)</u>	<u>(2,353)</u>
Bank balances at 30 June - Group	<u>774</u>	<u>1,312</u>
Bank deposits at 30 June - Group	<u>150,020</u>	<u>136,145</u>
(f) With Standard Chartered Bank		
Bank interest income earned by the Group for the year	<u>(5,681)</u>	<u>(143)</u>
Bank balances at 30 June - Group	<u>6</u>	<u>4</u>
Bank deposits at 30 June - Group	<u>100,685</u>	<u>35,000</u>

- (g) The Group provides clearing, settlement, depository, custody and nominee services to participant companies connected with all its members and had balances at the end of the current and prior financial year with these companies. Details of these transactions in respect of CCASS services and facilities utilised by the six members of the Company and their subsidiaries are as follows:—

	Group	
	1999 \$'000	1998 \$'000
Aggregate CCASS services fees charged by the Group for the year	<u>(82,093)</u>	<u>(139,256)</u>
Aggregate balances receivable by the Group at 30 June	<u>96,860</u>	<u>245,875</u>
Aggregate balances payable by the Group at 30 June	<u>(113,635)</u>	<u>(35,786)</u>

- (h) Loan facilities granted to the Company by the six members of the Company.

By agreements dated 13 June 1991, loan facilities of an aggregate amount of \$300 million were granted to the Company by the six members of the Company. The loan facilities granted and their drawdowns and repayments were in the proportion of 50% attributable to The Stock Exchange of Hong Kong Limited and 10% attributable to each of the five bank members of the Company. These loan facilities are secured by a debenture creating a fixed and floating charge over the assets of the Company.

The major terms of the loan facilities, as revised by amendment agreements dated 28 May 1992, are as follows:—

- the loan facilities are revolving loan facilities with amounts repaid available for reborrowing subject to aggregate reduction at each annual repayment date;

- repayment of any outstanding loan will be by predetermined annual minimum amounts and all outstanding loans shall be repaid in full by 30 June 2002;
- interest is calculated at the Hong Kong Interbank Offered Rate plus 2 per cent per annum payable at the end of each interest period; and
- the Company has the option to make early repayment by notice without penalty.

The maximum aggregate loan facilities available to the Company during the current and future years are as follows:—

	<i>\$Million</i>
during 30.6.1998 to 29.6.1999	195.0
during 30.6.1999 to 29.6.2000	165.0
during 30.6.2000 to 29.6.2001	135.0
during 30.6.2001 to 29.6.2002	105.0
at or after 30.6.2002	Nil

These facilities were not utilised during the year ended 30 June 1999. These facilities were terminated at the request of the Company on 15 December 1998 together with cancellation of the security debenture.

- (i) Banking facilities granted to the Company by the six members of the Company.

By agreements dated 15 December 1998, the Company has obtained from its six members banking facilities of \$600 million of which each member has granted \$100 million. These facilities were not utilised during the year ended 30 June 1999. Details of the terms of the facilities are set out in note 23 on the accounts. Details of fees on the facilities payable to the six members of the Company are borne by the CCASS Guarantee Fund and not by the Company, and are set out in the following paragraph.

- (j) The CCASS Guarantee Fund, for which separate accounts have been prepared, also had balances at the end of the current and prior financial year and had the following material transactions during the year with the six members of the Company, details of which are as follows:—

	CCASS Guarantee Fund Accounts	
	1999 \$'000	1998 \$'000
Bank interest income earned by the CCASS Guarantee Fund for the year from:—		
The Hongkong and Shanghai Banking Corporation Limited	(3,399)	(22)
Bank of China	(6,910)	(7,766)
The Bank of East Asia, Limited	(4,010)	(4,233)
Hang Seng Bank Limited	(3,782)	(527)
Standard Chartered Bank	(206)	—
	<u>(18,307)</u>	<u>(12,548)</u>
Bank charges incurred by the CCASS Guarantee Fund in respect of the banking facilities mentioned in note 20 (i) and note 23 on the accounts:—		
Front-end fee payable to the six members of the Company	1,500	—
Commitment fee payable to the six members of the Company	407	—
Security Trustees' fees payable to The Hongkong and Shanghai Banking Corporation Limited	44	—
	<u>1,951</u>	<u>—</u>
Bank balances and bank deposits at 30 June of the CCASS Guarantee Fund maintained with:—		
The Hongkong and Shanghai Banking Corporation Limited - bank balances and deposits	64,933	1,267
Bank of China - bank deposits	66,337	104,230
The Bank of East Asia, Limited - bank deposits	16,711	73,706
Hang Seng Bank Limited - banks deposits	42,067	50,000
Standard Chartered Bank - bank deposits	31,112	—
	<u>221,160</u>	<u>229,203</u>

21. Commitments

At the end of the year, the Company and the Group had the following commitments in respect of capital expenditure and under operating leases as follows:—

	Company and Group	
	1999	1998
	\$'000	\$'000
(a) Capital Expenditure		
Contracted for	—	—
Authorised but not contracted for	<u>5,996</u>	<u>24,933</u>
	<u>5,996</u>	<u>24,933</u>
(b) Commitments under Operating Leases to make payments in the following year are as follows:—		
In respect of land and buildings		
Leases expiring within 1 year	7,983	174
Leases expiring after 1 year but within 5 years	17,738	34,521
In respect of computer hardware and software Leases expiring after 1 year but within 5 years	<u>1,379</u>	<u>960</u>
	<u>27,100</u>	<u>35,655</u>

22. Off Balance Sheet Risks

The rules of the Stock Exchange provide that all Stock Exchange trading members and dealing partnerships are required to participate in CCASS as broker participants and cause all their Stock Exchange trades in eligible securities to be settled through CCASS. The CNS system interposes the Company between broker participants in securities clearing and settlement. As a result, the Company provides a form of 'guarantee' to broker participants in respect of Stock Exchange trades accepted for settlement under CNS. If a broker participant fails to fulfil its CNS settlement obligations, the Company could be exposed to potential market risk not otherwise included in the Balance Sheets. In the course of providing clearing and settlement services to broker participants, the Company has a significant concentration of market risk since its broker participants may be affected by economic conditions affecting the securities industry.

The Company mitigates its exposure to risk by requiring broker participants to meet the established financial standards for membership required by the Stock Exchange and statutory regulations, monitoring compliance with risk management measures established by the Company and requiring broker participants to contribute to the Guarantee Fund.

If a broker participant fails to fulfil its CNS settlement obligations with the Company, the Company will liquidate that participant's guaranteed securities delivery and receipt obligations and will apply its contribution to the Guarantee Fund to satisfy any net outstanding obligation and/or loss. If a deficiency still exists, the Company may apply contributions to the Guarantee Fund made by all other broker participants on a pro-rata basis.

Under the General Rules of CCASS, depositing participants are responsible to the Company for any defects affecting securities deposited by them into CCASS. The Company is responsible to withdrawing participants for any such defect affecting securities withdrawn by them from CCASS. If a depositing participant fails to fulfill its obligations for defective securities, the Company could be exposed to a potential risk not otherwise accounted for in the Balance Sheets. The aforesaid mitigating measures and liquidating procedures equally apply to the risk in respect of defective securities attributable to broker participants. Other participants are also required to meet established financial standards and criteria for admission into CCASS and compliance with risk management measures in respect of defective securities established and monitored by the Company. Insurance has also been effected to cover the risk of defective securities.

23. Banking Facilities

By agreements dated 15 December 1998, banking facilities on a committed basis of an aggregate amount of \$1,100 million (1998: nil) were granted to the Company by the six members of the Company and five other banks, i.e. each of them has granted \$100 million banking facility to the Company. The banking facilities are to provide stand-by liquidity to meet the Company's obligations in CCASS in circumstances where participants default on their payment obligations. The banking facilities granted and their drawdowns and repayments are on a pro-rata basis for all the eleven lenders. These banking facilities are secured by a debenture creating a floating charge over the assets of the Company.

The major terms and conditions of the banking facilities are as follows:—

- the facilities are revolving banking facilities on a committed basis with amounts repaid available for reborrowing;
- interest is calculated at the Hong Kong Interbank Offered Rate plus 2 per cent per annum payable at the end of each interest period;
- the facilities may be extended on an annual basis and a front-end fee of 0.25 per cent of the amount of the facilities is payable at the beginning and on each renewal of the facilities;
- a commitment fee of 0.125 per cent per annum is payable quarterly in arrears on undrawn facilities;
- drawdowns are subject to the condition that the Company has utilised all its available cash and bank deposits other than amounts retained for three months' operating expenses of the Company;
- the Company shall maintain reserves of not less than \$300 million and shall secure excess insurance cover for the CCASS Guarantee Fund of not less than \$200 million at all times.

These banking facilities were not utilised during the year ended 30 June 1999. Legal fees and bank charges on these banking facilities were borne by the CCASS Guarantee Fund and not by Company.

24. United Kingdom Stamp Duty Reserve Tax

The Company was contacted by the Stamp Office of the United Kingdom Inland Revenue in 1998 seeking information about how the share dealing systems in Hong Kong currently work in order to establish whether any transfers of shares of United Kingdom (UK) incorporated companies into CCASS would trigger a liability to United Kingdom Stamp Duty Reserve Tax (UK SDRT).

UK SDRT is a tax on agreements to transfer chargeable securities (which broadly refer to shares or securities of UK incorporated companies) for money or money's worth unless there is an existing instrument of transfer duly chargeable to UK stamp duty or the agreement is exempted therefrom. UK SDRT is a different tax from the normal UK stamp duty and is intended to remedy UK stamp duty avoidance on paperless transfers of shares without the use of written instruments of transfer, e.g. transfers under an electronic clearing system. UK SDRT has specific application to clearance services in that UK SDRT is triggered whenever chargeable securities are transferred or issued to the clearance service provider or its nominee. As a result of legislative enactment in the UK, as from 1 July 1996, UK SDRT can apply to overseas transfer agreements, whether or not the transactions are effected in the UK and whether or not any party to the transfer is resident in the UK.

The Group has not received any further enquiries from the UK Inland Revenue Stamp Office after the latter's initial requests for information in 1998. No demand for UK SDRT has been received by the Group to date and the Group is not aware of any legal action taken by the authorities in the UK in this respect to date. The Company has requested the assistance of the Government of the Hong Kong Special Administrative Region to raise the issue with the relevant UK authorities in order to obtain a satisfactory outcome.

On the basis of legal opinions obtained from UK Queen's Counsel, the Group will not have to make any payment for UK SDRT or suffer any penalty in respect thereof.

25. Comparative Figures

Certain comparative figures in the accounts have been reclassified to conform to the current year's presentation.

2. AUDITED OPERATING STATEMENT OF THE GUARANTEE FUND ESTABLISHED BY CCASS

REPORT OF THE AUDITORS

On the Guarantee Fund Established Under CCASS General Rule 2501

**Report of the Auditors to the Members of
Hong Kong Securities Clearing Company Limited**
(incorporated in Hong Kong with limited liability)

We have audited the accounts on pages 163 to 171 of the Guarantee Fund established under Rule 2501 of the General Rules of the Central Clearing and Settlement System which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective Responsibilities of Directors and Auditors

The General Rules of the Central Clearing and Settlement System require the directors to prepare accounts of the Guarantee Fund and the directors do so on the basis that these accounts should give a true and fair view. In preparing accounts 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 accounts and to report our opinion to you.

Basis of Opinion

We conducted our audit in accordance with Statements of Auditing Standards issued by the Hong Kong Society of Accountants. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the accounts. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the accounts, and of whether the accounting policies are appropriate to the Guarantee 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 accounts are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the accounts. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion, the accounts give a true and fair view, in all material respects, of the state of affairs of the Guarantee Fund as at 30 June 1999 and of its surplus and cash flows for the year then ended and have been properly prepared in accordance with accounting principles generally accepted in Hong Kong and are consistent with the provisions of Chapter 25 of the General Rules of the Central Clearing and Settlement System.

KPMG
Certified Public Accountants

Hong Kong, 5 August 1999

OPERATING STATEMENT

Of the Guarantee Fund Established Under CCASS General Rule 2501

for the year ended 30 June 1999

Expressed in Hong Kong dollars

	<i>Note</i>	1999 \$'000	1998 \$'000
Income			
Interest income on broker participants' contributions		6,588	6,943
Interest income on contribution from Hong Kong Securities Clearing Company Limited		<u>17,456</u>	<u>9,950</u>
	2(b)	<u>24,044</u>	<u>16,893</u>
Expenditure			
Legal fees		283	25
Interest to broker participants	2(b)	1,939	1,982
Bank charges	4	3,540	—
Insurance		<u>4,882</u>	<u>3,162</u>
		<u>10,644</u>	<u>5,169</u>
Surplus for the year		13,400	11,724
Retained surplus at the beginning of the year		<u>24,740</u>	<u>13,016</u>
Retained surplus at the end of the year	8	<u><u>38,140</u></u>	<u><u>24,740</u></u>

BALANCE SHEET

Of the Guarantee Fund Established Under CCASS General Rule 2501

at 30 June 1999

Expressed in Hong Kong dollars

	<i>Note</i>	1999 \$'000	1998 \$'000
Contributions Receivable from Broker Participants			
— fully secured by bank guarantees issued by authorized banks		<u>30,380</u>	<u>21,960</u>
Current Assets			
Insurance premium prepaid		1,726	2,032
Interest receivable		7,978	5,367
Cash at banks	5	<u>311,587</u>	<u>303,951</u>
		<u>321,291</u>	<u>311,350</u>
Current Liabilities			
Additional cash contributions collected from broker participants		—	200
Contributions refundable and received in advance		2,790	1,420
Interest payable to broker participants		200	570
Other payables and accruals		<u>81</u>	<u>—</u>
		<u>3,071</u>	<u>2,190</u>
Net Current Assets		<u>318,220</u>	<u>309,160</u>
		<u>348,600</u>	<u>331,120</u>
Representing:			
Broker Participants' Contributions	6	110,460	106,380
Contribution from Hong Kong Securities Clearing Company Limited	7	200,000	200,000
Retained Surplus	8	<u>38,140</u>	<u>24,740</u>
		<u>348,600</u>	<u>331,120</u>

CASH FLOW STATEMENT

Of the Guarantee Fund Established Under CCASS General Rule 2501

for the year ended 30 June 1999

Expressed in Hong Kong dollars

	<i>Note</i>	1999 \$'000	1998 \$'000
Net Cash Outflow from Operating Activities	9(b)	<u>(7,148)</u>	<u>(4,174)</u>
Returns on Investments and Servicing of Finance			
Interest received		21,433	14,079
Interest paid		<u>(2,309)</u>	<u>(1,835)</u>
Net cash inflow from returns on investments and servicing of finance		<u>19,124</u>	<u>12,244</u>
Investing Activities			
Increase in deposits with banks maturing in 3 months or more when acquired		<u>(8,310)</u>	<u>(108,722)</u>
Net cash outflow from investing activities		<u>(8,310)</u>	<u>(108,722)</u>
Net cash inflow/(outflow) before financing		<u>3,666</u>	<u>(100,652)</u>
Financing			
(Decrease)/Increase in broker participants' contributions received in cash	6(b)	(4,340)	1,220
Increase in Contribution from Hong Kong Securities Clearing Company Limited	7	<u>—</u>	<u>100,000</u>
Net cash (outflow)/inflow from financing		<u>(4,340)</u>	<u>101,220</u>
(Decrease)/increase in Cash and Cash Equivalents		(674)	568
Cash and cash equivalents at the beginning of the year		<u>1,267</u>	<u>699</u>
Cash and cash equivalents at the end of the year	9(c)	<u><u>593</u></u>	<u><u>1,267</u></u>

NOTES ON THE ACCOUNTS

Of the Guarantee Fund Established Under CCASS General Rule 2501
Expressed in Hong Kong dollars

1. Status and Operation of the Guarantee Fund

Rule 2501 of the General Rules of the Central Clearing and Settlement System (CCASS) and CCASS Operational Procedures provide that a Guarantee Fund shall be established by way of contributions from broker participants in amounts pro-rata to their turnover market share in The Stock Exchange of Hong Kong Limited (Stock Exchange). The Guarantee Fund is to provide resources to enable Hong Kong Securities Clearing Company Limited (the Company) to discharge the obligations and liabilities of defaulting broker participants arising from their Stock Exchange trades accepted for settlement on a continuous net settlement (CNS) basis and defective securities deposited into CCASS which have been 'guaranteed' by the Company under the CCASS General Rules.

The Company has prescribed that the initial minimum contributed fund will be \$100 million. Each broker participant will contribute to the minimum contributed fund, in proportion to its turnover market share subject to a minimum amount of \$50,000 in cash for every 'A' share held in the Stock Exchange with the balance in cash or by way of bank guarantees or in such other form as is acceptable to the Company. The Company will utilise the interest income generated from the minimum cash contributions to arrange insurance cover and such other arrangements to top up the contributed fund as may be appropriate. Broker participants will earn interest at the prevailing Hong Kong dollar savings bank account deposit rate on contributions made in cash which are in excess of the minimum amount required.

Application of the Fund is governed by the CCASS General Rules. Rule 2506 provides that the Fund may be applied towards the obligations and liabilities of the Company arising from Stock Exchange trades accepted for CNS settlement upon default by broker participants and for liabilities on defective securities deposited by broker participants. Rule 2507 stipulates that the contributions of the responsible broker participant in default shall first be applied and then the contributions of all other broker participants shall be applied on a pro-rata basis. Any amount of the Fund utilised shall be replenished by broker participants.

The administration of the Fund and the investment of the Fund's assets are governed by the Risk Management Committee which reports to the Board of Directors of the Company.

2. Principal Accounting Policies

These accounts have been prepared in accordance with Statements of Standard Accounting Practice issued by the Hong Kong Society of Accountants and accounting principles generally accepted in Hong Kong. A summary of the principal accounting policies adopted by the Guarantee Fund is set out below.

(a) Scope of the Accounts

The accounts incorporate only those assets, liabilities and operating results accruing to the Guarantee Fund in accordance with the CCASS General Rules. Other collateral collected by the Company from broker participants in the course of daily CCASS operations is not dealt with in these accounts but in the accounts of the Company.

(b) Interest Income and Expense

Interest income and expense are recognised in the operating statement on a time apportioned basis based on the principal amounts outstanding at the applicable rates of interest.

(c) Application of Fund

Provision will be made in these accounts immediately the Company has knowledge of the occurrence of events qualifying for the application of the Fund under the CCASS General Rules.

3. Administrative Expenses

Administrative expenses of the Guarantee Fund for the year are borne by the Company and are not recharged to the Fund, including audit fees for the audit of the accounts of the Guarantee Fund for the current and prior years.

4. Bank Charges

	1999 \$'000	1998 \$'000
Bank charges on the \$1,100 million stand-by banking facilities as detailed in note 12 on the accounts		
Front end fee at 0.25%	2,750	—
Commitment fee at 0.125% p.a. and Security Trustees' Fees	<u>790</u>	<u>—</u>
	<u>3,540</u>	<u>—</u>

5. Cash at Banks

	1999 \$'000	1998 \$'000
Bank time deposits		
- maturing in 3 months or more when acquired	310,994	302,684
Bank savings account balances	<u>593</u>	<u>1,267</u>
	<u>311,587</u>	<u>303,951</u>

6. Broker Participants' Contributions

	1999 \$'000	1998 \$'000
(a) Broker Participants' Contributions comprised of:—		
Minimum contributions payable in cash at \$50,000 for every "A" share held in the Stock Exchange by each broker participant 846 (1998: 875) "A" shares held	42,300	43,750
Other contributions payable in cash or by way of bank guarantees or in such other form as is acceptable to the Company	<u>68,160</u>	<u>62,630</u>
	<u>110,460</u>	<u>106,380</u>
Representing:—		
Contributions receivable at the end of the year and fully secured by bank guarantees	30,380	21,960
Contributions received in cash	<u>80,080</u>	<u>84,420</u>
	<u>110,460</u>	<u>106,380</u>
(b) Movements in Broker Participants' Contributions received in cash during the year were as follows:—		
At the beginning of the year	84,420	83,200
(Decrease)/increase during the year	<u>(4,340)</u>	<u>1,220</u>
At the end of the year	<u>80,080</u>	<u>84,420</u>

7. Contribution from Hong Kong Securities Clearing Company Limited

The Company has contributed an aggregate amount of \$200 million (1998: \$200 million) in cash to provide additional resources to the Guarantee Fund, which will be considered to be utilised, where appropriate, by the Risk Management Committee only after exhaustion of the broker participants' contributions and the purchased insurance cover. The contributions are administered by the Risk Management Committee of the Company. The contributions will be refundable to the Company when the Risk Management Committee considers that they are in excess of the total resources required by the Guarantee Fund.

	1999 \$'000	1998 \$'000
Movements in contribution during the year were as follows:—		
At the beginning of the year	200,000	100,000
Increase during the year	<u>—</u>	<u>100,000</u>
At the end of the year	<u>200,000</u>	<u>200,000</u>

8. Retained Surplus

	1999 \$'000	1998 \$'000
Retained surplus at 30 June represents:—		
Aggregate interest income on contributions from the Company	36,865	19,409
Other operating surplus	<u>1,275</u>	<u>5,331</u>
	<u>38,140</u>	<u>24,740</u>

9. Cash Flow Statement Analysis**(a) Cash and Cash Equivalents in Cash Flow Statement**

Cash is defined as cash in hand and deposits repayable on demand with any bank or other financial institution. Cash equivalents are defined as short-term highly liquid investments which are readily convertible into known amounts of cash without notice and which were within three months of maturity when acquired; less advances from banks repayable within three months from the date of the advance. Cash flow is defined as an increase or decrease in cash or cash equivalents resulting from a transaction.

	1999 \$'000	1998 \$'000
(b) Reconciliation of Surplus for the year to Net Cash Outflow from Operating Activities		
Surplus for the year	13,400	11,724
Interest income	(24,044)	(16,893)
Interest expenses	1,939	1,982
Decrease/(increase) in insurance premium prepaid and interest receivable	306	(1,347)
Increase in additional cash contributions, contributions refundable and received in advance, and other payables and accruals	<u>1,251</u>	<u>360</u>
Net cash outflow from operating activities for the year	<u>(7,148)</u>	<u>(4,174)</u>
(c) Analysis of Balances of Cash and Cash Equivalents		
Cash at banks	<u>593</u>	<u>1,267</u>

10. Related Party Transactions

For the purpose of these accounts, parties are considered to be related to the Guarantee Fund if the parties have the ability, directly or indirectly, to control the Guarantee Fund or exercise significant influence over the Guarantee Fund in making financial and operating decisions, or vice versa, or where the Guarantee Fund and the parties are subject to common control or common significant influence. Related parties may be individuals or other entities.

During the year, the Guarantee Fund had balances at the end of the current and prior financial year and had the following material transactions with the six members of the Company, which were undertaken on normal commercial terms in the ordinary course of business:—

	1999 \$'000	1998 \$'000
(a) Bank interest income earned for the year from:—		
The Hongkong and Shanghai Banking Corporation Limited	(3,399)	(22)
Bank of China	(6,910)	(7,766)
The Bank of East Asia, Limited	(4,010)	(4,233)
Hang Seng Bank Limited	(3,782)	(527)
Standard Chartered Bank	(206)	—
	<u>(18,307)</u>	<u>(12,548)</u>
(b) Bank charges incurred in respect of the banking facilities mentioned in note 12 on these accounts:—		
Front-end fee payable to the six members of the Company	1,500	—
Commitment fee payable to the six members of the Company	407	—
Security Trustees' fees payable to The Hongkong and Shanghai Banking Corporation Limited	44	—
	<u>1,951</u>	<u>—</u>
(c) Bank balances and bank deposits at 30 June maintained with:—		
The Hongkong and Shanghai Banking Corporation Limited — bank balances and deposits	64,933	1,267
Bank of China — bank deposits	66,337	104,230
The Bank of East Asia, Limited — bank deposits	16,711	73,706
Hang Seng Bank Limited — banks deposits	42,067	50,000
Standard Chartered Bank — bank deposits	31,112	—
	<u>221,160</u>	<u>229,203</u>
(d) Banking facilities granted to the Company by the six members of the Company		

By agreements dated 15 December 1998, the Company has obtained from its six members banking facilities of \$600 million of which each member has granted \$100 million. These facilities were not utilised during the year ended 30 June 1999. Details of the terms of the facilities are set out in note 12 on these accounts. Details of fees on the facilities payable to the six members of the Company are borne by the Guarantee Fund and not by the Company, and are set out in the above paragraph (b).

11. Arrangements to Provide Additional Resources to the Guarantee Fund

In addition to the minimum contributed fund described in note 1 on the accounts relating to the Guarantee Fund, CCASS General Rule 2504 provides that the Company may from time to time establish such additional arrangements, including bank facilities and insurance policies, as it considers appropriate, for the purposes of providing additional resources to the Guarantee Fund.

The following arrangements have been made to provide additional resources:—

- (a) The Company has purchased \$500 million (1998: \$500 million) insurance cover with a self-insured excess of \$100 million (1998: \$100 million).
- (b) The Company has contributed an aggregate of \$200 million (1998: \$200 million) in cash to the Fund. These contributions will be utilised only after exhaustion of the minimum contributed fund and the secured insurance cover.

12. Banking Facilities

By agreements dated 15 December 1998, banking facilities on a committed basis of an aggregate amount of \$1,100 million (1998: nil) were granted to the Company by the six members of the Company and five other banks, i.e. each of them has granted \$100 million banking facility to the Company. The banking facilities are to provide stand-by liquidity to meet the Company's obligations in CCASS in circumstances where participants default on their payment obligations. The banking facilities granted and their drawdowns and repayments are on a pro-rata basis for all the eleven lenders. These banking facilities are secured by a debenture creating a floating charge over the assets of the Company.

The major terms and conditions of the banking facilities are as follows:—

- the facilities are revolving banking facilities on a committed basis with amounts repaid available for reborrowing;
- interest is calculated at the Hong Kong Interbank Offered Rate plus 2 per cent per annum payable at the end of each interest period;
- the facilities may be extended on an annual basis and a front-end fee of 0.25 per cent of the amount of the facilities is payable at the beginning and on each renewal of the facilities;
- a commitment fee of 0.125 per cent per annum is payable quarterly in arrears on undrawn facilities;
- drawdowns are subject to the condition that the Company has utilised all its available cash and bank deposits other than amounts retained for three months' operating expenses of the Company;
- the Company shall maintain reserves of not less than \$300 million and shall secure excess insurance cover for the Guarantee Fund of not less than \$200 million at all times.

These banking facilities were not utilised during the year ended 30 June 1999. Legal fees and bank charges of these banking facilities were borne by the Guarantee Fund and not by the Company.

New Articles of Association of HKEC will need to be adopted by HKEC, subject to the approval of the Securities and Futures Commission and the Stock Exchange Scheme and Futures Exchange Scheme becoming effective. The following is a summary of certain provisions of the draft new Articles of Association (the "Articles") of HKEC, which provisions may be amended prior to the Effective Date to, inter alia, conform with any requirements of the Enabling Legislation. The summary below uses the definitions set out therein and any reference to the "Company" means HKEC:

(a) **Alteration of capital**

The Company may from time to time by ordinary resolution increase its capital by the creation of new shares of such amount as may be deemed expedient.

The Company may from time to time by ordinary resolution:

- (i) consolidate and divide all or any of its share capital into shares of a larger amount than its existing shares;
- (ii) cancel any shares which, at the date of the passing of the resolution, have not been taken or agreed to be taken by any person and diminish the amount of its share capital by the amount of the shares so cancelled; and
- (iii) sub-divide its existing shares or any of them into shares of smaller amount than is fixed by its memorandum of association and the resolution may determine that, as between the holders of the shares resulting from such sub-division, one or more of the shares may have such preferred or other special rights, or may have such qualified or deferred rights or be subject to such restrictions, as the Company has power to attach to new shares,

subject nevertheless to the provisions of the Companies Ordinance and every other ordinance concerning companies and affecting the Company (together, the "Statutes").

Subject to the provisions of the Statutes and the Articles, the Company may by special resolution reduce its share capital, any capital redemption reserve, any share premium account or any other undistributable reserve in any way.

(b) **Variation of rights**

Whenever the capital of the Company is divided into different classes of shares, all or any of the special rights or privileges attached to any class may (whether or not the Company is being wound up) be varied or abrogated with the consent in writing of the holders of three-fourths in nominal value of the issued shares of that class, or with the sanction of a special resolution passed at a separate general meeting of the holders of such shares. To every such separate general meeting all the provisions of the Articles relating to general meetings of the Company or to the proceedings thereat shall *mutatis mutandis* apply, except that the necessary quorum shall be two persons holding or representing by proxy not less than one-third in nominal amount of the issued shares of the class, that every holder of shares of the class shall be entitled on a poll to one vote for every share of the class held by him, that any holder of shares of the class present in person or by proxy may demand a poll and that at an adjourned meeting one person holding shares of the class present in person or by proxy shall be a quorum.

(c) **Votes of members**

Subject to any special rights or restrictions as to voting for the time being attached to any shares and to the provisions of the Articles, on a show of hands every member who is present in person at a general meeting of the Company shall have one vote and on a poll every member who is present in person or by proxy shall have one vote for every share of which he is the holder.

A member of the Company, being a recognised clearing house within the meaning of the Securities and Futures (Clearing Houses) Ordinance of Hong Kong or its nominee, may authorise such person or persons as it thinks fit to act as its representative (or representatives) at any general meeting of the Company or at any separate meeting of any class of members provided that, if more than one person is so authorised, the authorisation must specify the number and class of shares in respect of which each such person is so authorised. The person so authorised will be entitled to exercise the same power on behalf of the clearing house (or its nominee) as if such person was the registered holder of the shares of the Company held by the clearing house (or its nominee), including the right to vote individually on a show of hands.

(d) **Directors**

Unless otherwise determined by an ordinary resolution of the members of the Company and approved by the Securities and Futures Commission ("Commission"), the number of Directors shall be not less than two and not more than fifteen. A Director need not be a member of the Company.

The Company may by ordinary resolution elect any person to be a Director, either to fill a casual vacancy or by way of an addition to their number, but so that the total number of Directors elected under this paragraph shall not at any time exceed six. The Financial Secretary may at any time:

- (i) appoint in writing any person as a Director representing the public interest (a "Public Interest Director"); and
- (ii) remove from office, in writing, any person so appointed,

provided that the number of Directors from time to time appointed by the Financial Secretary shall not exceed eight.

The Chief Executive Officer of the Company shall, ex-officio, be a Director.

Without prejudice to the power of the Company in general meeting in accordance with any of the provisions of the Articles to appoint any person to be a Director, the Directors may, at any time, and from time to time, appoint any person to be a Director (other than a Public Interest Director), either to fill a casual vacancy or by way of addition to their number but so that the total number of Directors (other than Public Interest Directors) shall not exceed six. Any Director so appointed by the Directors shall hold office only until the next following annual general meeting of the Company, and shall then be entitled for re-election.

At each annual general meeting any Director (other than a Public Interest Director and the Chief Executive Officer) then in office who has been appointed by the Directors since the previous annual general meeting or at the date of the notice convening the annual general meeting had held office for more than thirty months since he was appointed or last re-appointed by the Company in general meeting, shall retire from office but shall be eligible for re-appointment. Subject to certain exceptions, a retiring Director shall retain office until the close of the meeting at which he retires.

The Company may by special resolution remove any Director (other than a Public Interest Director or the Chief Executive Officer) before the expiration of his period of office. A Director (other than a Public Interest Director or the Chief Executive Officer) may also be removed from office by giving him notice to that effect signed by all the other Directors. Public Interest Directors may be removed by the Financial Secretary. A person appointed as Chief Executive Officer shall cease to be a Director if he ceases to hold the office of Chief Executive Officer of the Company.

The Directors may meet together for the despatch of business, adjourn and otherwise regulate their meetings as they think fit and may determine the quorum necessary for the transaction of business. Until otherwise determined by the Directors, four Directors shall be a quorum provided always that not less than half of such number of Directors as shall constitute a quorum from time to time shall be Public Interest Directors.

The ordinary remuneration of the Directors shall from time to time be determined by the Company in general meeting and such remuneration shall be divided among them in such proportion and manner as they may agree or, failing agreement, equally.

The Directors shall also be paid all their travelling, hotel and other expenses properly incurred by them in and about the discharge of their duties, including their expenses of travelling to and from meetings of the Directors, or committee meetings, or general meetings (subject always to the provisions of any agreement between the Company and any Director).

The Directors may grant special remuneration to any Director who, being called upon, shall perform any special or extra services to or at the request of the Company. Such special remuneration may be made payable to such Director in addition to or in substitution for his ordinary remuneration (if any) as a Director and may be made payable by a lump sum or by way of salary, commission, participation in profits or otherwise as the Directors may decide.

(e) **Directors' interests**

Subject to the Statutes, no Director or intending Director shall be disqualified by his office from contracting with the Company, either with regard to his tenure of any office or position in the management, *administration or conduct of the business of the Company or as vendor, purchaser or otherwise, nor (subject to the interest of the Director being duly declared) shall any contract or arrangement entered into by or on behalf of the Company in which any Director is in any way interested, be liable to be avoided, nor shall any Director so contracting or being so interested be liable to account to the Company for any profit realised by any such contract or arrangement by reason of such Director holding that office or of the fiduciary relationship thereby established.*

A Director may hold any other office or place of profit with the Company (except that of auditor) in conjunction with his office of Director for such period (subject to the Statutes) and upon such terms as the Directors may decide and may be paid such extra remuneration for so doing (whether by way of salary, commission, participation in profits or otherwise) as the Directors may decide, either in addition to or in lieu of any remuneration under any other provision of the Articles.

Any Director may act by himself or his firm in a professional capacity for the Company (otherwise than as auditor), and he or his firm shall be entitled to remuneration for professional services as if he were not a Director.

Any Director may continue to be or become a member or director of, or hold any other office or place of profit under, any other company in which the Company may be interested, and no such Director shall be accountable for any dividend, remuneration, superannuating payment or other benefits received by him as a *member or director of, or holder of any other office or place of profit under, any such other company.* The Directors may also cause any voting power conferred by the shares in any other company held or owned by the Company or any power of appointment to be exercised in such manner in all respects as they think fit, including the exercise of the voting power or power of appointment in favour of the appointment of the directors or any of them as *directors or officers of the other company or in favour of the payment of remuneration to the directors or officers of the other company.*

A Director who is in any way, whether directly or indirectly, interested in a contract or proposed contract with the Company shall, if his interest in such contract or proposed contract is material, declare the nature of his interest at a meeting of the Directors at which the question of entering into the contract is first taken into consideration, if he knows his interest then exists, or in any other case at the first meeting of the Directors after he knows that he is or has become so interested. For this purpose, a general notice given to the Directors by a Director to the effect that (a) he is a member of a specified company or firm and is to be regarded as interested in any other contract which may after the date of the notice be made with that company or firm, or (b) he is to be regarded as interested in any contract which may after the date of the notice be made with a specified person who is connected with him, shall be deemed to be a sufficient declaration of interest in relation to any such contract but no such notice shall be effective unless either it is given at a Directors' meeting or the Director takes reasonable steps to secure that it is brought up and read at the next Directors' meeting after it is given.

A Director shall not vote (or be counted in the quorum at a meeting) in relation to any resolution relating to any contract or arrangement or other proposal in which he has an interest which (taken together with any interest of any person connected with him) is to his knowledge a material interest and, if he purports to do so, his vote shall not be counted, but this prohibition shall not apply and a Director may vote (and be counted in the quorum) in respect of any resolution concerning any one or more of the following matters:

- (i) the giving to him of any guarantee, indemnity or security in respect of money lent or obligations undertaken by him at the request of or for the benefit of the Company or any of its subsidiaries;
 - (ii) the giving to a third party of any guarantee, indemnity or security in respect of a debt or obligation of the Company or any of its subsidiaries for which he himself has assumed responsibility in whole or in part and whether alone or jointly under a guarantee or indemnity or by the giving of security;
 - (iii) where the Company or any of its subsidiaries is offering securities in which offer the Director is or may be entitled to participate as a holder of securities or in the underwriting or sub-underwriting of which the Director is to participate;
 - (iv) any contract in which he is interested in the same manner as other holders of shares or debentures or other securities of the Company by virtue only of his interest in shares or debentures or other securities of the Company;
 - (v) any contract concerning any other company (not being a company in which the Director and his associates own 5 per cent. or more of any class of equity share capital or of the voting rights) in which he is interested directly or indirectly as an officer or shareholder;
 - (vi) any contract concerning the adoption, modification or operation of a pension fund or retirement, death or disability benefits scheme which relates both to Directors and employees of the Company or of any of its subsidiaries and does not provide in respect of any Director as such any privilege or advantage not accorded to the employees to which the fund or scheme relates;
 - (vii) any contract for the benefit of employees of the Company or of any of its subsidiaries under which he benefits in a similar manner to the employees and which does not accord to any Director as such any privilege or advantage not accorded to the employees to whom the contract relates; and
 - (viii) any contract for the purchase or maintenance for any Director or Directors of insurance against any liability.
- (f) **Borrowing powers**

Subject to the provisions of the Articles, the Directors may exercise all the powers of the Company to borrow money and to mortgage or charge the whole or any part of its undertaking, property and assets (both present and future) and uncalled capital of the Company and (subject to the provisions of the Statutes) to issue debentures and other securities, whether outright or as collateral security for any debt, liability or obligation of the Company or of any third party. These powers, as with other provisions of the Articles, may be altered by a special resolution of the Company and prior approval of the Commission.

(g) **Committees and Panels**

The Directors may from time to time appoint committees consisting of such member or members of their body and/or such other person(s) as they think fit, and may delegate any of their powers to any such committee, and from time to time revoke any such delegation and discharge any such committee wholly or in part.

Without limiting the generality of the above and unless otherwise agreed by the Commission, the Directors shall provide for the creation of the following committees and panels:

- (i) an Executive Committee comprising the Chairman, the Chief Executive Officer, the Chief Operating Officer and two other Directors, which Committee shall be responsible for reviewing key issues related to the Company's strategy and operation, preparing submissions to the Directors, making operational decisions on listing and regulatory issues and deciding on key personnel recruitment, evaluation and compensation;
 - (ii) a Management Committee comprising the Chief Executive Officer, the Chief Operating Officer and such officers or employees as the Directors believe are representative of the business units within, and functions carried out by, the Company, which Committee shall be responsible for co-ordinating among business units and functions, resolving cross units issues, initiating synergy capture and operational improvements and building a common operating mode and culture;
 - (iii) a Risk Management Committee comprising three Directors and three to five other persons (who are not Directors) approved by the Directors, which Committee shall be responsible for reviewing the *risk management procedures of the Company and its subsidiaries, including assessing changes in minimum capital reserve requirements, margining levels and counter party risk limits*; and
 - (iv) such other committees and panels comprising of Directors, officers and/or members of the public and with such powers and functions as may be specified by law or in any regulation imposed on or applicable to the Company.
- (h) **Chairman, Chief Executive Officer, Chief Operating Officer, etc.**

Subject to the following paragraphs, the Directors may from time to time (a) appoint one or more of their number or any other person to any office or employment under the Company (including, but without limitation, that of Chairman, Chief Executive Officer or Chief Operating Officer) for such period and on such terms as the Directors think fit, and may also permit any person appointed to be a Director to continue in any office or employment held by him before he was so appointed, and (b) remove him or them from office and appoint another or others in his place or their places.

Any appointment of a person to the office of Chairman by the Directors shall be subject to (and effective only upon) the written approval of such appointment by the Chief Executive of Hong Kong. The Chairman shall be a *non-executive Director and shall be appointed for an initial term of three years and may be re-appointed for a further period or periods up to a maximum of six consecutive years (including the initial term of three years)*. A person may only be removed from his office as Chairman by (a) a resolution of the Directors passed by *two-thirds of the Directors from time to time*; or (b) *written notice from the Chief Executive of Hong Kong removing him from his office on grounds of public interest or the interests of the investing public*.

Any appointment of a person to the office of Chief Executive Officer or Chief Operating Officer by the Directors shall be subject to (and effective only upon) (a) the Chairman providing his prior written recommendation to the appointment; and (b) the written approval of the Commission.

A person may only be removed from his office as Chief Executive Officer or Chief Operating Officer by (a) a resolution of the Directors passed by a simple majority of the Directors if such removal has been *recommended by the Chairman*; or (b) *written notice from the Commission removing him from his office on grounds of public interest or the interests of the investing public (following consultation by the Commission with the Chairman and the Financial Secretary)*. Any such person removed from office by the Commission shall be entitled to appeal, in writing, his removal to the Chief Executive of Hong Kong.

The remuneration and other terms and conditions of appointment of a person (including a Director) appointed to any office or employment under the Company pursuant to the above paragraphs in this section (h) shall from time to time (without prejudice to the provisions of any agreement between him and the Company) be fixed by the Directors and may be by way of fixed salary, commission, participation in profits or otherwise and either in addition to or inclusive of his remuneration as a Director.

(i) Dividends

Subject to the provisions of the Statutes, the Company may, from time to time, by ordinary resolution declare a dividend to be paid to the members, according to their rights and interests in the profits, and may fix the time for payment of such dividend. No dividend shall exceed the amount recommended by the Directors.

Subject to the provisions of the Statutes and of the Articles and to any rights, privileges or restrictions for the time being attached to any shares in the capital of the Company having preferential or special rights in regard to dividend, the profits of the Company which it shall from time to time be determined to distribute by way of dividend shall be applied in payment of dividends upon the shares of the Company in proportion to the amounts paid up thereon respectively otherwise than in advance of calls, provided that if any share be issued upon terms providing that it shall rank for dividend as from or after a particular date, or be entitled to dividends declared or paid after a particular date, such share shall rank for or be entitled to dividend accordingly.

Subject to the provisions of the Statutes, if and to the extent that the Directors think fit and the position of the Company in their opinion justifies such payment, the Directors may declare and pay dividends on shares carrying an entitlement to fixed dividends in accordance with the rights attached thereto and may also from time to time declare and pay interim dividends on shares of any class of such amounts and on such dates and in respect of such periods as they think fit.

With the sanction of an ordinary resolution of the Company and upon the recommendation of the Directors any dividend may be paid and satisfied, either wholly or in part, by the distribution of specific assets, and in particular of paid-up shares or debentures of any other company, or partly in one way and partly in another or others, and where any difficulty arises in regard to the distribution, the Directors may settle the same as they think expedient, and in particular they may issue fractional certificates, and may fix the value for distribution of such specific assets or any part thereof, and may determine that cash payments shall be made to any members upon the footing of the value so fixed in order to adjust the rights of all parties, and may vest any such specific assets in trustees upon such trusts for the persons entitled to the dividend as may seem expedient to the Directors.

In respect of any dividend proposed to be paid or declared by the Directors or by the Company in general meeting, the Directors may offer, prior to or contemporaneously with the payment or declaration of such dividend, members the right to elect to receive shares, credited as fully paid, instead of cash in respect of all (or some part) of such dividend.

The Directors may deduct from any dividend or other moneys payable in respect of any shares held by a member, either alone or jointly with any other member, all such sums of money (if any) presently due and payable by him, either alone or jointly with any other person, to the Company in relation to shares of the Company.

All unclaimed dividends may be invested or otherwise made use of by the Directors as they shall think fit, until the same be claimed and so that the Company shall not thereby be constituted as a trustee in respect thereof and any dividend unclaimed after a period of six years from the date for payment of such dividend shall be forfeited and shall revert to the Company.

(j) Five per cent. limitation on shareholdings

The Articles contain provisions (the "Shareholding Article") which prevent any person (other than a Permitted Person) being, or being deemed or appearing to the Directors to be, interested in shares of the Company which carry the right to more than 5 per cent. of the votes which could be cast on any resolution at any general meeting of the Company.

For the purposes of the Shareholding Article:

- (i) "Depositary" means a custodian or other person (in either case approved in writing by the Directors for the purposes of this paragraph) who enters into arrangements with the Company for facilitating investors to acquire, hold and deal in shares or interests in shares in the Company or securities

representing such shares or interests, whereby such custodian or other person holds or is interested in the shares in which such investors are interested, but shall not include any such custodian or other person whose approval by the Directors is withdrawn by them by notice given to such custodian or other person in consequence of a breach of its obligations under such arrangements;

- (ii) "Depositary Shares" means shares in the Company held by a Depositary or in which such Depositary is interested in its capacity as a Depositary;
- (iii) "interest" means:
 - (A) any interest which would be taken into account in determining for the purposes of the SDI Ordinance (assuming the Company is a listed company under that Ordinance) whether a person has a notifiable interest in a share (including any interest which he would be taken as having for those purposes);
 - (B) any interest in any security representing a share or an interest in a share; and
 - (C) in relation to a person, any interest of persons with whom he is acting in concert within the meaning of the Hong Kong Code on Takeovers and Mergers (with the exception that the reference to the 35 per cent. control threshold (or such other percentage as shall from time to time constitute control for those purposes) shall be lowered to 5 per cent.);

and "interested" shall be construed accordingly, provided, however, that for the avoidance of doubt, an "interest" shall not include any exempt security interest as referred to in section 14 of the SDI Ordinance;

- (iv) "Permitted Person" means:
 - (A) a clearing house (or its nominee), acting in its capacity as such;
 - (B) the chairman of a meeting of the Company or of a meeting of the holders of Relevant Share Capital or of any class thereof when exercising the voting rights conferred on him as part of the Share Restrictions (as defined below);
 - (C) a trustee (acting in that capacity) of any employees' share scheme of the Company;
 - (D) the Government and any other person acting on behalf of the Government;
 - (E) any person who has obtained a waiver (with or without conditions) from the provisions of the Shareholding Article from the Commission in consultation with the Financial Secretary;
 - (F) any person who has an interest but who, if the incidents of his interest were governed by the laws of Hong Kong, would in the opinion of the Directors be regarded as a bare trustee of that interest, in respect of that interest only;
 - (G) a Depositary in respect of the Depositary Shares held by it;
 - (H) an underwriter in respect of interests in shares which exist only by virtue of a contingent obligation to take up such shares pursuant to an underwriting or sub-underwriting agreement or, for a period of three months, in respect of interests in shares taken up pursuant to such an obligation;
 - (I) any other person who subscribes or otherwise acquires Relevant Share Capital (or interests therein) which has been allotted or issued with a view to that person (or purchasers from that person) offering the same to the public, for a period not exceeding three months from the date of the relevant allotment or issue; or

- (J) any person who has an interest in shares, and who shows to the satisfaction of the Directors that he has it, by virtue only of being the holding company of a company which is a Permitted Person within (A) to (I) above;
- (v) "Relevant Share Capital" means shares in the Company which carry (or may, according to their terms, in certain circumstances carry) the right to vote on any resolution at any general meeting of the Company (whether or not the right is exercisable in relation to all resolutions at all general meetings);
- (vi) "Required Disposal" means a disposal or disposals of, or of interests in, such number of Restricted Shares as will cause a Restricted Person to cease to be a Restricted Person, not being a disposal to another Restricted Person (other than a Permitted Person) or a disposal which constitutes any other person (other than a Permitted Person) a Restricted Person;
- (vii) "Restricted Person" means any person who has, or who appears to the Directors to have, an interest in shares which carry (or may in certain circumstances carry) more than 5 per cent. of the votes which could be cast on any resolution at any general meeting of the Company (whether or not the votes could be cast in relation to all resolutions at all general meetings);
- (viii) "Restricted Shares" means all shares in the Relevant Share Capital in which a Restricted Person has, or appears to the Directors to have, or is deemed to have, an interest; and
- (ix) "SDI Ordinance" means the Securities (Disclosure of Interests) Ordinance (Chapter 396 of the Laws of Hong Kong);

and where the Directors resolve that they have made reasonable enquiries and that they are unable to determine whether or not a person has an interest in any particular shares comprised in Relevant Share Capital, the shares concerned shall be deemed to be Restricted Shares and all persons interested or appearing to the Directors to be interested in them to be Restricted Persons.

Subject to the provisions of this paragraph, the provisions of the SDI Ordinance shall apply in relation to the Company as if:

- (a) the Company was a listed company under the SDI Ordinance;
- (b) those provisions extended to the interests referred to in subparagraph (iii)(B) above;
- (c) the notifiable percentage for the purpose of the SDI Ordinance is 5 per cent.; and
- (d) all shares in the Relevant Share Capital formed part of the relevant share capital as defined in the SDI Ordinance;

and accordingly the rights and obligations arising under the SDI Ordinance shall apply in relation to the Company, its members and all persons interested in Relevant Share Capital, as extended by this paragraph (except, for the avoidance of doubt, those obligations requiring notification to be made to the Stock Exchange).

The Directors may by notice in writing ("Disclosure Notice") require any member, or any other person appearing to be interested or appearing to have been interested in the shares of the Company, to disclose to the Company in writing such information as the Directors shall require relating to the ownership of or interests in the shares in question as lies within the knowledge of such member or other person (supported if the Directors so require by a statutory declaration and/or by independent evidence) including (without prejudice to the generality of the foregoing):

- (i) any information which the Company would be entitled to seek pursuant to Section 18 of the SDI Ordinance (assuming the Company is a listed company under the SDI Ordinance);

- (ii) any information which the Directors shall deem necessary or desirable in order to determine whether any shares or rights to subscribe for, or convert into, shares of the Company are Restricted Shares; and
- (iii) any information which the Directors shall deem necessary or desirable in order to determine whether any person is or is deemed to be a Restricted Person or otherwise in relation to the application or potential application of the Shareholding Article.

If the Directors shall become aware, or shall consider, that any person other than a Permitted Person has become or is deemed to have become a Restricted Person, the Directors may serve a written notice (a "Disposal Notice") on all persons (other than persons whose identity or address is not known), who appear to the Directors to have interests in (and, if different, are the registered holders of) the Restricted Shares. Such notice shall set out the Share Restrictions (as defined below) and shall call for a Required Disposal to be made within 21 days of the service of the notice on the registered holder, or within such longer period as the Directors consider reasonable. The Directors may extend the period in which such notice is required to be complied with and may withdraw any such notice (whether before or after the expiration of the period referred to) if it appears to them that there is no Restricted Person in relation to the shares concerned. Upon the giving of such notice, and save for the purpose of a Required Disposal under this paragraph or the following paragraph, no transfer of any of the Restricted Shares may be registered until either such notice is withdrawn or a Required Disposal has been made to the satisfaction of the Directors and registered.

If a Disposal Notice has not been complied with in all respects to the satisfaction of the Directors and has not been withdrawn, the Directors shall, so far as they are able, make a Required Disposal and shall give written notice of such disposal to those persons on whom such notice was served. The Restricted Person(s), the registered holder(s) of and any other person interested in the shares disposed of shall be deemed to have irrevocably and unconditionally authorised the Directors to make such Required Disposal. The manner, timing and terms of any such Required Disposal made or sought to be made by the Directors (including but not limited to the price or prices at which the same is made and the extent to which assurance is obtained that no transferee, with the exception of a Permitted Person, is or would become a Restricted Person) shall be such as the Directors determine, based upon advice from bankers, brokers or other appropriate persons consulted by them for the purpose, to be reasonably practicable having regard to all the circumstances, including but not limited to the number of shares to be disposed of and the requirement that the disposal be made without delay; and the Directors shall not be liable to any person for any of the consequences of reliance on such advice. If on a Required Disposal being made by the Directors, Restricted Shares are held by more than one registered holder (treating joint holders as a single holder) the Directors shall (as nearly as may be practicable) cause the same proportion of each registered holding to be sold.

For the purpose of effecting any Required Disposal, the Directors may authorise in writing any officer or employee of the Company to execute any necessary transfer on behalf of any registered holder, may enter the name of the transferee in the Register as the holder of the transferred shares notwithstanding the absence of any share certificate being lodged in respect thereof, and may issue a new certificate to the transferee. Interests or rights and the title of the transferee shall not be affected by any irregularity or invalidity in the proceedings relating thereto. The net proceeds of such disposal shall be received by the Company, whose receipt shall be a good discharge for the purchase money, and shall be paid (without interest and after deduction of any expenses incurred by the Directors on the sale) to the former registered holder (or, in the case of joint holders, the holder whose name stands first in the Register in respect of the joint holding) upon surrender by him or on his behalf of any certificate in respect of the Restricted Shares sold and formerly held by him.

A holder of a Restricted Share on whom a Disposal Notice has been served shall not in respect of that share be entitled, until such time as the notice has been complied with to the satisfaction of the Directors or withdrawn, to attend or vote at any general meeting of the Company or meeting of the holders of Relevant Share Capital or of any class thereof, and the rights to attend (whether in person or by proxy), to speak and to demand and vote on a poll which but for the provisions of this paragraph would have attached to the Restricted Share shall vest in the chairman of such meeting (collectively, the "Share Restrictions"). The manner in which the chairman exercises or refrains from exercising any such rights shall be entirely at his discretion. The chairman of any such meeting as aforesaid shall be informed by the Directors of any share becoming or being deemed to be a Restricted Share.

Any resolution or determination of, or decision or exercise of any discretion or power by, the Directors or any Director or any chairman of any meeting under or pursuant to the provisions of the Shareholding Article (including without prejudice to the generality of the foregoing as to what constitutes reasonable enquiry or as to the manner, timing and terms of any Required Disposal made by the Directors following non-compliance with a Disposal Notice in any respect) shall be final and conclusive; and any disposal or transfer made, or other thing done, by or on behalf of, or on the authority of, the Directors or any Director pursuant to the foregoing provisions of the Shareholding Article shall be conclusive and binding on all persons concerned and shall not be open to challenge, whether as to its validity or otherwise on any ground whatsoever.

The Shareholding Article shall apply notwithstanding any provision in the Articles to the contrary.

(k) Transfer of shares

Subject to the Statutes and the restrictions in the Articles, a member may transfer all or any of his shares by an instrument of transfer in any usual form or in such other form as the Directors may approve. The instrument of transfer of a share shall be signed by or on behalf of the transferor and the transferee (provided that the Directors may dispense with the signing of the instrument of transfer by the transferee in any case which they think fit in their discretion to do so), and the transferor shall be deemed to remain the holder of the share until the name of the transferee is entered in the Register in respect thereof. The machine imprinted signature on an instrument of transfer may be accepted by the Company for the purpose of such transfer subject to any terms which the Company may impose. Shares of different classes shall not be comprised in the same instrument of transfer. All instruments of transfer which shall be registered may be retained by the Company. Nothing in the Articles shall preclude the Directors from recognising a renunciation of the allotment of any share by the allottee in favour of some other person.

The Directors may in their absolute discretion and without assigning any reason, refuse to register any transfer of any share which is not fully paid up or on which the Company has a lien.

The Directors may also refuse to register any transfer unless:

- (i) the instrument of transfer is in respect of only one class of shares;
- (ii) in the case of a transfer to joint holders, the number of joint holders to whom the share is to be transferred does not exceed four;
- (iii) subject to the Statutes, the instrument of transfer is lodged with the Company accompanied by the certificate for the shares to be transferred (except where the shares are registered in the name of a person to whom no certificate has been issued) and such other evidence (if any) as the Directors may reasonably require to prove the title of the intending transferor or his right to transfer the shares; and
- (iv) the instrument of transfer is accompanied by payment of such fee as the Directors may from time to time require.

If the Directors refuse to register any transfer of any share, they shall, within two months after the date on which the transfer was lodged with the Company, send to the transferor and the transferee notice of the refusal.

(l) Purchase of own shares and warrants

Subject to the provisions of the Statutes and any rules prescribed by any stock exchange on which the shares of the Company are listed and permitted to be dealt in (including the Stock Exchange) from time to time, the Company may purchase its own shares of any class in the capital of the Company, including any redeemable shares or warrants or other securities carrying a right to subscribe for or purchase shares of the Company issued by the Company and, should the Company acquire its own shares or warrants or other such securities,

neither the Company nor the Directors shall be required to select the shares or warrants to be acquired rateably or in any other particular manner as between the holders of shares or warrants of the same class or as between them and the holders of shares or warrants of any other class or in accordance with the rights as to dividends or capital conferred by any class of shares or warrants.

(m) Rule for division of assets in liquidation

If the Company shall be wound up, the surplus assets remaining after payment of all creditors shall be divided among the members in proportion to the capital which at the commencement of the winding up is paid up, or ought to have been paid up, on the shares held by them respectively and, if such surplus assets shall be insufficient to repay the whole of the paid-up capital, they shall be distributed so that, as nearly as may be, the losses shall be borne by the members in proportion to the capital paid up, or which ought to have been paid up, at the commencement of the winding up on the shares held by them respectively. But such provision is to be subject to the rights attached to any shares which may be issued on special terms or conditions.

(n) Amendment

The provisions of the Articles may not be amended without the prior approval of the Commission.

The following describes briefly the main features of the Enabling Legislation as currently proposed by the Government. There may be further revisions to them as a result of further legal and policy considerations arising in the course of drafting and the legislative process.

Recognised exchange holding company

- 1 Any person who in association or otherwise holds a material interest in an exchange company or clearing house that is approved, authorised or recognised under the relevant legislation has to be recognised by the SFC as a “recognised exchange holding company” (“REHC”). An REHC would be regulated by the SFC and the SFC may withdraw such recognition on the grounds of public interest or the interests of the investing public.
- 2 An REHC would have the statutory duty, *inter alia*:
 - (a) to ensure the operation of an orderly and fair securities and futures market by its subsidiary exchange companies and clearing houses;
 - (b) to ensure that risks associated therewith are managed prudently; and
 - (c) to ensure compliance by its subsidiaries with all their constitutional and statutory obligations.
- 3 The appointment of the chairman of an REHC would have to be approved by the Chief Executive of Hong Kong. The appointment of the chief executive and chief operating officer of an REHC would have to be approved by the SFC. The Chief Executive of Hong Kong may remove the chairman and the SFC may remove the chief executive and the chief operating officer of an REHC on the grounds of public interest or the interests of the investing public.
- 4 The SFC may make rules relating to the ownership, legal and beneficial, and control of an REHC. Any changes in an REHC's ownership in or control of an exchange company or a clearing house would also be subject to the SFC's approval.
- 5 The constitution and rules of an REHC (including instruments setting out its fees and charges) or any amendments thereto made by an REHC will not have effect unless approved by the SFC.
- 6 Consequential amendments would also be made to the relevant legislation relating to the regulation of the securities and futures markets in Hong Kong for the proper and effective regulation of an REHC and its subsidiary exchange companies and clearing houses in a manner similar to the present legislation regulating the Exchanges and Clearing Houses. Amendments would also be made to reflect the removal of the requirement that a member (or “exchange participant” in future) be at the same time a shareholder of an exchange company.
- 7 Legislative amendments would be made so that after the merger only “exchange participants” would be eligible for registration as electors for the Financial Services Functional Constituency for the purposes of the Legislative Council Election in 2000.

Specific provisions applicable to HKEC

- 8 HKEC would be deemed to be an REHC by the Enabling Legislation.
- 9 The Stock Exchange would continue to enjoy its current monopoly to establish, operate and maintain a stock market in Hong Kong and such monopoly would be extended to HKEC and any subsidiary of HKEC which is recognised as an Exchange Company under the Stock Exchanges Unification Ordinance.
- 10 HKEC would be required to establish a risk management committee to formulate policies on risk management matters for the markets in securities and commodities and for clearing houses. The chairman of HKEC would be the chairman of the risk management committee. The Financial Secretary of Hong Kong and the HKEC Board may appoint persons as members of the risk management committee. The decisions of the risk management committee could only be overruled by a two thirds majority of the HKEC Board.
- 11 The Financial Secretary of Hong Kong may appoint not more than eight directors to the HKEC Board to represent the interests of the public. The HKEC Directors so appointed can only be removed by the Financial Secretary of Hong Kong.
- 12 Appropriate provision would be made for the SFC to supervise HKEC's compliance with the Stock Exchange's listing rules in relation to HKEC's own listing.
- 13 HKEC would be deemed to be a public body for the purposes of the Prevention of Bribery Ordinance (Chapter 201 of the Laws of Hong Kong).

Conversion of HKSCC to a company limited by shares

- 14 HKSCC would be converted from a company limited by guarantee to a company limited by shares and become a wholly owned subsidiary of HKEC (without the need for HKEC to pay any consideration for this purpose). The guarantees given by the existing guarantors would be released.

The Government announced in the 1999/2000 Budget in March 1999 that it will consolidate and modernise the existing legislation (*see footnote*) governing the securities and futures markets and clearing houses into a single piece of legislation. The current draft of the legislation, to be called the Securities and Futures Bill (the "Composite Bill"), is targeted to be presented to the Legislative Council before the end of 1999. **This Composite Bill is independent and does not form part of the Enabling Legislation. It does not govern the implementation of the Overall Proposal (including the Stock Exchange Scheme and the Futures Exchange Scheme).** Similarly, the Overall Proposal will not affect the Government's plan to introduce the Composite Bill into the Legislative Council. Drafting of the Composite Bill and consultation on the new proposals are still in progress. Guides to the principal elements of the Composite Bill were issued in July and are available at the SFC's web-site (www.hksfc.org.hk). **The following briefly describes the current proposals of the Government in that part of the Composite Bill which relates solely to exchange companies and clearing houses and which does not appear in the Enabling Legislation. There may be further revisions to them as a result of further legal and policy considerations arising in the course of drafting and the legislative process, and the ongoing consultation exercise:**

- (a) the definitions of terms such as "securities" and "futures contracts" will be updated and improved. The SFC would be empowered to prescribe other new financial products to be regarded, and traded, as "securities" or "futures contracts" to provide greater flexibility for the SFC to facilitate market development;
- (b) definitions of "rules" of recognised exchange companies and clearing houses, and comparable procedures under which rules and rule changes require approval from the SFC will be standardised;
- (c) every recognised exchange company and clearing house will be required to enforce its rules and to maintain adequate personnel and systems with adequate capacity, security, and contingency plans. This is to take account of the fact that modern trading systems are highly automated;
- (d) a new investor compensation framework to replace the compensation funds currently established under the Securities Ordinance and the Commodities Trading Ordinance will be provided. The new framework will facilitate a uniform basis for establishing a mechanism to avoid moral hazard, while providing adequate levels of compensation and equitable treatment for different types of investors. Until these new arrangements are in place, the existing compensation fund arrangements, applicable to the clients of exchange participants, will remain in force.

The Securities and Futures Commission Ordinance (Cap. 24), Securities Ordinance (Cap. 333), Commodity Exchanges (Prohibition) Ordinance (Cap. 82), Commodities Trading Ordinance (Cap. 250), Protection of Investors Ordinance (Cap. 335), Stock Exchanges Unification Ordinance (Cap. 361), Securities and Futures (Clearing Houses) Ordinance (Cap. 420), Securities (Disclosure of Interests) Ordinance (Cap.396), Securities (Insider Dealing) Ordinance (Cap. 395).

1. RESPONSIBILITY STATEMENTS

The information in this document relating to the Stock Exchange has been supplied by the Stock Exchange. The issue of this document has been approved by the Council and the Council Members jointly and severally accept responsibility for the accuracy of the information contained in this document (save for the Letter from HKEC, appendices I, III, IV, V, VI) and VII to this document and the information in appendix VIII to this document relating to HKEC, the Futures Exchange Group or the HKSCC Group (the "Excluded Information"). The Council Members confirm, in respect of all information herein other than the Excluded Information, having made all reasonable enquiries, that to the best of their knowledge, opinions expressed herein have been arrived at after due and careful consideration and there are no facts, not contained herein, the omission of which would make any statement herein misleading.

The Excluded Information has been supplied by the HKEC Directors or, in the case of appendix III to this document and other information relating to the Futures Exchange Group, derived by HKEC Directors from the circular relating to the Futures Exchange Proposal enclosed with this document. The issue of this document has been approved by the HKEC Directors, who jointly and severally accept responsibility for the accuracy of the Excluded Information and, in respect of the Excluded Information, confirm, having made all reasonable enquiries that, to the best of their knowledge, opinions expressed therein have been arrived at after due and careful consideration and there are no facts, not contained therein, the omission of which would make any statement therein misleading.

2. DISCLOSURE OF INTERESTS AND DEALINGS

(a) Interests in Stock Exchange Shares

As at the Latest Practicable Date:

- (i) the following Council Members have interests (which, if the SDI Ordinance were to apply to the Council Members and the Stock Exchange, would have been discloseable under Part III of the SDI Ordinance (including interests which the Council Members would be deemed or be taken to have under Section 31 of, or Part I of the Schedule to, the SDI Ordinance) ("Interests")) in Stock Exchange Shares:

Council Member	Stock Exchange Shareholder	Number of Stock Exchange Share(s)
Au Chong Kit, Stanley	Delta Asia Securities Limited	3
Syed Bagh Ali Shah Bokhary	Bokhary Securities Limited	1
Cheung Wah Fung	Christfund Securities Limited	6
Chu Ho Miu Hing	Good Harvest Securities Company Limited	1
Tsang Chi Suen, Trini	Grand Onward Securities Limited	1

Each of these Council Members has confirmed that the Stock Exchange Shareholder in which the relevant Council Member has an interest intends to vote in favour of the Stock Exchange Proposal.

- (ii) Mr. Dannis Lee, an HKEC Director, through DL Brokerage Limited (a company beneficially wholly owned by Mr. Dannis Lee), owned two Stock Exchange Shares.
- (iii) Merrill Lynch Far East Limited, a company controlled by the Independent Financial Adviser, beneficially owned four Stock Exchange Shares. Additionally, Merrill Lynch Futures (Hong Kong) Limited, a company under the same control as the Independent Financial Adviser, held one Futures Exchange Share.
- (iv) Mr. Nicholas Peter Etches, Mr. Alan Chung Wah Tang and Mr. Gabriel Chi Kok Tam, partners of KPMG, the accounting adviser to HKEC, are liquidators of Chark Fung Securities Company Limited which, as at the Latest Practicable Date, held two Stock Exchange Shares.

Save as set out above, as at the Latest Practicable Date:

- (i) neither HKEC, nor any of the parties acting in concert with it, owned or controlled any Stock Exchange Shares;
- (ii) none of the Council Members, or the HKEC Directors, had any Interests in any Stock Exchange Shares; and
- (iii) no subsidiary of the Stock Exchange, pension fund of the Stock Exchange or of any subsidiary of the Stock Exchange, or adviser of the Stock Exchange (as specified in paragraph (2) of the definition of "associate" in the Takeovers Code) owned or controlled any Stock Exchange Shares.

(b) Interests in HKEC Shares

As at the Latest Practicable Date:

- (i) neither the Stock Exchange, nor any party acting in concert with HKEC, owned or controlled any HKEC Shares (save for The Financial Secretary Incorporated which beneficially owned two HKEC Shares);
- (ii) none of the Council Members, nor any of the HKEC Directors, had any Interests in any HKEC Shares; and
- (iii) no subsidiary of the Stock Exchange, or any pension fund of the Stock Exchange or of any subsidiary of the Stock Exchange, or adviser of the Stock Exchange (as specified in paragraph (2) of the definition of "associate" in the Takeovers Code), owned or controlled any HKEC Shares.

(c) Dealings in Stock Exchange Shares

Mr. Syed Bokhary, a Council Member, transferred the Stock Exchange Share owned by him to Bokhary Securities Limited, a company wholly controlled by Mr. Bokhary and his wife, for a nominal consideration on 27th November, 1998.

Save as disclosed above, during the period commencing six months prior to 3rd March, 1999 and ending on the Latest Practicable Date:

- (i) neither HKEC, nor any of the parties acting in concert with HKEC, dealt for value in Stock Exchange Shares;
- (ii) none of the Council Members, nor any of the HKEC Directors, dealt for value in any Stock Exchange Shares;
- (iii) no subsidiary of the Stock Exchange, or any pension fund of the Stock Exchange or of any subsidiary of the Stock Exchange, dealt for value in any Stock Exchange Shares; and
- (iv) no adviser of the Stock Exchange (as specified in paragraph (2) of the definition of "associate" in the Takeovers Code) or any other associate of the Stock Exchange dealt for value in any Stock Exchange Shares.

(d) Dealings in HKEC Shares

During the period commencing six months prior to 3rd March, 1999 and ending on the Latest Practicable Date:

- (i) neither the Stock Exchange, nor any of the parties acting in concert with HKEC, dealt for value in HKEC Shares;
- (ii) none of the Council Members, nor any of the HKEC Directors, dealt for value in any HKEC Shares;
- (iii) no subsidiary of the Stock Exchange, nor any pension fund of the Stock Exchange or of any subsidiary of the Stock Exchange, dealt for value in any HKEC Shares; and
- (iv) no adviser of the Stock Exchange (as specified in paragraph (2) of the definition of "associate" in the Takeovers Code) or any other associate of the Stock Exchange dealt for value in any HKEC Shares.

3. LITIGATION

- (a) No company in the Stock Exchange Group is engaged in any litigation or claims of material importance and, so far as the Council Members are aware, no litigation or claims of material importance are pending or threatened by or against any company in the Stock Exchange Group.
- (b) Neither HKEC nor (on the basis of the information contained in the circular relating to the Futures Exchange Proposal enclosed with this document) any company in the Futures Exchange Group or (on the basis of advice to the HKEC Directors from HKSCC) the HKSCC Group is engaged in any material litigation or claims of material importance and, so far as the HKEC Directors are aware, no litigation or claims of material importance are pending or threatened by or against HKEC, or (on the aforesaid basis) the Futures Exchange Group or (on the aforesaid basis) the HKSCC Group.

4. MATERIAL CONTRACTS

- (a) The Stock Exchange has conditionally agreed, under a funding letter entered into with HKEC on 30th July, 1999, to advance a loan of up to HK\$669.0 million to HKEC. The principal terms of the loan are set out in the paragraphs headed "Financing of the Stock Exchange Cash Alternative" in the Letter from HKEC. The advance of the loan is subject to the sanction of the Court under the Stock Exchange Scheme and the Stock Exchange Scheme becoming effective.

On 15th December, 1998 the Stock Exchange entered into an agreement with HKSCC to provide a HK\$100,000,000 revolving loan facility to HKSCC. Details of this loan are set out in note 19 to the financial statements of the Stock Exchange for the year ended 30th June, 1999 in appendix II to this document.

Save for the contracts referred to above, no company in the Stock Exchange Group has, within the two years prior to the Latest Practicable Date, entered into any material contracts, not being contracts entered into in the ordinary course of business carried on or intended to be carried on by the Stock Exchange Group.

- (b) Save for the funding letters both dated 30th July, 1999 from the Exchanges to HKEC and the facilities for HK\$600.0 million granted to HKEC by its banks, of which details are set out in the paragraphs headed "Financing of the Stock Exchange Cash Alternative" in the Letter from HKEC, neither HKEC nor (on the basis of the information contained in the circular relating to the Futures Exchange Proposal enclosed with this document) any company in the Futures Exchange Group or (on the basis of advice to the HKEC Directors from HKSCC) the HKSCC Group has, within the two years prior to the Latest Practicable Date, entered into any material contracts, not being contracts entered into in the ordinary course of business carried on or intended to be carried on by HKEC, or (on the aforesaid basis) the Futures Exchange Group or (on the aforesaid basis) the HKSCC Group, as applicable.

5. MISCELLANEOUS

- (a) It is not proposed that any benefits will be given to any Council Member as compensation for loss of office or otherwise in connection with the Stock Exchange Proposal.
- (b) Save in respect of the proposed cancellation of the Stock Exchange Scheme Shares held by Stock Exchange Shareholders and the allotment and issue to Stock Exchange Shareholders of HKEC Shares and/or the payment of cash under the Stock Exchange Cash Alternative, no agreement or arrangement exists between HKEC and any of the Council Members or any other person or between any of the Council Members and any other person which is conditional upon the outcome of the Stock Exchange Proposal or otherwise in connection with the Stock Exchange Proposal.
- (c) No material contract has been entered into by HKEC in which any Council Member has a material personal interest.

- (d) None of the Council Members has a service contract with any member of the Stock Exchange Group in force which has more than 12 months to run or which has been entered into or amended within the period commencing 6 months before 3rd March, 1999 and ending on the Latest Practicable Date. The terms of the current service contract of Alec Tsui Yiu Wa, Chief Executive of the Stock Exchange, are as follows:
- (i) the expiry date of the service contract is 31st January, 2000;
 - (ii) the amount of fixed remuneration payable to him under the service contract (excluding arrangements for provident fund contributions) is HK\$5,212,800 per year; and
 - (iii) there are no variable payments relating to remuneration under the contract.

The Stock Exchange has exercised its option to extend the appointment of Alec Tsui Yiu Wa as Chief Executive from 1st February, 2000 for a period of two years, but the terms of his appointment have not yet been discussed.

- (e) No agreement, arrangement or understanding exists whereby any new Stock Exchange Shares to be issued to HKEC pursuant to the Stock Exchange Scheme will be transferred to any other person.
- (f) The Stock Exchange was incorporated in Hong Kong on 7th July, 1980. Its registered office is at 1st Floor, One and Two Exchange Square, Central, Hong Kong.
- (g) HKEC was incorporated in Hong Kong on 8th July, 1999. Its registered office is at 18th Floor, Admiralty Centre, Tower I, 18 Harcourt Road, Hong Kong.
- (h) The Secretary of the Stock Exchange is Tsang Chiu Wan.
- (i) It is estimated that the costs, charges and expenses of and incidental to the Stock Exchange Scheme and the costs of carrying the same into effect to be borne by the Stock Exchange will amount to approximately HK\$20 million. HKEC will bear its own costs, charges and expenses in connection with the Stock Exchange Scheme.
- (j) As required under the Takeovers Code, all announcements in relation to the Stock Exchange Proposal, in respect of which the Executive has confirmed that it has no further comments, must be published as paid announcements in the Newspapers.
- (k) As required under the Takeovers Code, HKEC shall immediately inform the Executive that the Stock Exchange Scheme has been revised or extended, has expired or has become or has been completed and shall publish an announcement in accordance with paragraph (j) above on the following day to that effect.
- (l) The English text of this document and the accompanying forms of proxy and Form of Election shall prevail over the Chinese text.
- (m) The registered office of HKEC's Financial Adviser is at 1 Queen's Road Central, Hong Kong. HKEC's Financial Adviser is an exempt dealer under the Securities Ordinance and a licensed bank under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong).

- (n) The registered office of the Independent Financial Adviser is at 15th Floor, St George's Building, 2 Ice House Street, Central, Hong Kong. The Independent Financial Adviser is a registered securities dealer and investment adviser under the Securities Ordinance.

6. CONSENTS

HKEC's Financial Adviser, the Independent Financial Adviser, Ernst & Young, KPMG and PricewaterhouseCoopers have given and have not withdrawn their respective written consents to the issue of this document with the inclusion therein of copies of their respective reports and/or letters and/or the references to their names and/or their reports, and/or letters, in the form and context in which they respectively appear.

7. DOCUMENTS AVAILABLE FOR INSPECTION

Copies of the following documents will be available for inspection at the registered office of the Stock Exchange at 1st Floor, One and Two Exchange Square, Central, Hong Kong and at the offices of Linklaters at 10th Floor, Alexandra House, Chater Road, Hong Kong during normal business hours on any business day until the Effective Date:

- (a) the Memorandum and Articles of Association of the Stock Exchange and the Memorandum and Articles of Association of HKEC;
- (b) the proposed amended Memorandum of Association and Articles of Association of the Stock Exchange that will take effect immediately subject to the amendments being approved at the Extraordinary General Meeting;
- (c) the proposed amended Memorandum of Association and the proposed new Articles of Association of the Stock Exchange, both of which will take effect upon completion of the Stock Exchange Proposal subject to their being approved at the Extraordinary General Meeting;
- (d) the proposed new Articles of Association of HKEC which are summarised in appendix V;
- (e) the audited consolidated financial statements of the Stock Exchange for each of the years ended 30th June, 1998 and 1999;
- (f) the letter from the Independent Financial Adviser, the text of which is set out on pages 14 to 28 of this document;
- (g) the material contracts of the Stock Exchange referred to under the heading "Material contracts" in this appendix;
- (h) the letters of consent referred to under the heading "Consents" in this appendix;
- (i) the Policy Paper; and
- (j) the Position Paper.

SCHEME OF ARRANGEMENT

HCMP 5122/99

**IN THE HIGH COURT OF
THE HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
MISCELLANEOUS PROCEEDINGS NO. 5122 OF 1999**

**IN THE MATTER
of
THE STOCK EXCHANGE OF HONG KONG LIMITED
and
IN THE MATTER of the Companies Ordinance,
CHAPTER 32 OF THE LAWS OF HONG KONG**

**SCHEME OF ARRANGEMENT
under Section 166 of the Companies Ordinance,
CHAPTER 32 OF THE LAWS OF HONG KONG
between
THE STOCK EXCHANGE OF HONG KONG LIMITED
and
THE HOLDERS OF STOCK EXCHANGE SCHEME SHARES
(as hereinafter defined)**

PRELIMINARY

(A) In this Stock Exchange Scheme, the following expressions shall have the meanings respectively set opposite them:

“business day” a day on which the Stock Exchange is open for the business of dealing in securities;

SCHEME OF ARRANGEMENT

“Companies Ordinance”	the Companies Ordinance, Chapter 32 of the Laws of Hong Kong;
“Court”	the High Court of the Hong Kong Special Administrative Region;
“Effective Date”	the day on which this Stock Exchange Scheme becomes effective in accordance with Clause 12 of this Stock Exchange Scheme;
“Election Deadline”	a business day which shall not be less than 7 days before the Effective Date and shall be notified to the holders of Stock Exchange Scheme Shares in accordance with Clause 5 of this Stock Exchange Scheme;
“Form of Election”	the form of election prescribed by HKEC which may be lodged by a holder of Stock Exchange Scheme Shares pursuant to Clause 4 of this Stock Exchange Scheme for the purpose of electing for cash in place of some or all of the HKEC Shares to which he would have become entitled pursuant to this Stock Exchange Scheme;
“Futures Exchange”	Hong Kong Futures Exchange Limited, a public company incorporated in Hong Kong with limited liability;
“Futures Exchange Scheme”	the scheme of arrangement under section 166 of the Companies Ordinance pursuant to which the Futures Exchange will become a wholly owned subsidiary of HKEC;
“HKEC”	Hong Kong Exchanges and Clearing Limited, a private company incorporated in Hong Kong with limited liability;
“HKEC Shares”	ordinary shares of HK\$1.00 each in the capital of HKEC;
“holder”	a registered holder;
“Record Date”	the business day immediately preceding the Effective Date;
“Stock Exchange”	The Stock Exchange of Hong Kong Limited, a public company incorporated in Hong Kong with limited liability;

SCHEME OF ARRANGEMENT

“Stock Exchange Cash Limit”	HK\$935,200,000, being the maximum amount of cash available for the payment to all holders of Stock Exchange Scheme Shares electing to receive cash pursuant to Clause 4 of this Stock Exchange Scheme in place of some or all of the HKEC Shares to which the holders would have become entitled pursuant to this Stock Exchange Scheme;
“Stock Exchange Scheme”	this scheme of arrangement in its present form or with or subject to any modification thereof or addition thereto or condition approved or imposed by the Court;
“Stock Exchange Scheme Shares”	the fully paid Stock Exchange Shares in issue at the close of business on the Record Date;
“Stock Exchange Shares”	“A” shares of HK\$1.00 each in the capital of the Stock Exchange; and
“HK\$”	Hong Kong dollars

- (B) The authorised share capital of the Stock Exchange as at the date hereof is \$1,200 divided into 1,200 Stock Exchange Shares 929 of which have been issued and are fully paid or credited as fully paid.
- (C) HKEC was on 8th July, 1999 incorporated under the Companies Ordinance as a private company limited by shares. The present authorised share capital of HKEC is HK\$1,000 divided into 1,000 HKEC Shares of which two HKEC Shares have been issued and are fully paid and are beneficially owned by The Financial Secretary Incorporated.
- (D) The primary purpose of this Stock Exchange Scheme is that the Stock Exchange shall become a wholly owned subsidiary of HKEC and that the holders of Stock Exchange Scheme Shares shall, subject to them electing for cash in place of some or all of their entitlements to HKEC Shares, become shareholders of HKEC.
- (E) As at the date hereof, neither HKEC nor any of the holders of HKEC Shares holds or beneficially owns any Stock Exchange Scheme Shares.
- (F) By the direction of the Court, a meeting of its shareholders is being convened by the Futures Exchange for the purpose of considering and, if thought fit, approving the Futures Exchange Scheme.
- (G) HKEC has agreed to appear by Counsel at the hearing of the petition to sanction this Stock Exchange Scheme and to undertake to the Court to be bound thereby and to execute all such documents and to do all such acts and things as may be necessary or desirable to be executed or done by it for the purpose of giving effect to this Stock Exchange Scheme.

SCHEME OF ARRANGEMENT

THE SCHEME

PART I

HKEC

1. Subject to and conditional upon this Stock Exchange Scheme becoming effective, HKEC shall cease to be a private company in accordance with section 30 of the Companies Ordinance and shall increase its authorised share capital from HK\$1,000 to HK\$2,000,000,000 by the creation of an additional 1,999,999,000 HKEC Shares.

PART II

The Stock Exchange

2. On the Effective Date:—
 - (a) the authorised and issued share capital of the Stock Exchange shall be reduced by cancelling and extinguishing the Stock Exchange Scheme Shares;
 - (b) subject to and forthwith upon such reduction of capital taking effect, the authorised share capital of the Stock Exchange shall be increased to its former amount of HK\$1,200 by the creation of such number of new Stock Exchange Shares as is equal to the number of Stock Exchange Scheme Shares cancelled; and
 - (c) the Stock Exchange shall apply the credit arising in its books of account as a result of the reduction of its share capital referred to in paragraph (a) of this Clause 2 in paying up in full at par the new Stock Exchange Shares to be created as aforesaid, which new Stock Exchange Shares shall be allotted and issued, credited as fully paid, to HKEC and its nominee.

PART III

Consideration for the Cancellation of the Stock Exchange Scheme Shares

3. (a) In consideration of the cancellation of the Stock Exchange Scheme Shares and the allotment and issue to HKEC and its nominee of the new Stock Exchange Shares pursuant to Clause 2 of this Stock Exchange Scheme, HKEC shall, subject as provided in Clause 4 of this Stock Exchange Scheme in respect of the cash alternative, allot and issue to all holders of Stock Exchange Scheme Shares (as appearing in the register of members of the Stock Exchange at the close of business on the Record Date), for every Stock Exchange Scheme Share held, such number of HKEC Shares, credited as fully paid, as shall be equal to:

$$\frac{X}{Y}$$

SCHEME OF ARRANGEMENT

where

"X" is 747,845,000, being the maximum number of HKEC Shares to which holders of Stock Exchange Scheme Shares shall be entitled pursuant to this Stock Exchange Scheme; and

"Y" is the total number of the Stock Exchange Scheme Shares;

provided that the number of HKEC Shares to which any such holder is entitled in respect of each Stock Exchange Scheme Share shall be rounded down to the nearest whole number.

- (b) The HKEC Shares to be allotted and issued pursuant to paragraph (a) of this Clause 3 shall be identical, form one class with and rank pari passu in all respects with the other existing HKEC Shares.

PART IV

Cash Alternative to HKEC Shares

4. (a) Each holder of Stock Exchange Scheme Shares shall, subject to the Stock Exchange Cash Limit, be entitled to elect for cash in place of some or all of the HKEC Shares to which he would have become entitled pursuant to Clause 3 of this Stock Exchange Scheme by lodging at the registered office of the Stock Exchange on or before the Election Deadline a Form(s) of Election in the manner provided by Clause 6 of this Stock Exchange Scheme and, if such Form(s) of Election is accepted by HKEC in accordance with Clause 6 of this Stock Exchange Scheme, the provisions in paragraphs (b) to (d) of this Clause 4 shall apply.
- (b) As regards each Stock Exchange Scheme Share, the holder shall be entitled to receive payment, at the rate of HK\$3.88 per HKEC Share, for each HKEC Share specified in his Form of Election relating to that Stock Exchange Scheme Share in the event that such number of HKEC Shares does not exceed the Permitted HKEC Share Limit to be determined as follows:

$$\text{Permitted HKEC Share Limit} = \frac{A}{B} \times \frac{1}{Y}$$

where

"A" is HK\$935,200,000, being the amount of the Stock Exchange Cash Limit;

"B" is HK\$3.88, being the fixed amount for each HKEC Share specified in any Form of Election; and

"Y" is the total number of the Stock Exchange Scheme Shares;

provided that the Permitted HKEC Share Limit shall be rounded down to the nearest whole number.

SCHEME OF ARRANGEMENT

- (c) In the event that the aggregate value of the HKEC Shares (calculated at the rate of HK\$3.88 per HKEC Share) in respect of which holders of Stock Exchange Scheme Shares have elected to receive cash exceeds the Stock Exchange Cash Limit, then each holder who elected in his Form of Election to receive more HKEC Shares than the Permitted HKEC Share Limit for any Stock Exchange Scheme Share held shall be entitled to receive, as regards those HKEC Shares, payment of:
- (i) in respect of the Permitted HKEC Share Limit, HK\$3.88 per HKEC Share; and
 - (ii) as regards HKEC Shares in respect of which elections were made exceeding the Permitted HKEC Limit, after satisfying payment to all holders in respect of elections up to and including the Permitted HKEC Share Limit, such proportion of the remaining balance (if any) of the Stock Exchange Cash Limit which the number of excess HKEC Shares relating to that Stock Exchange Scheme Share, as specified in his Form of Election, bears to the aggregate number of the excess HKEC Shares specified in all the Forms of Election, provided however that any amount payable under this sub-paragraph (ii) shall be rounded down to the nearest whole multiple of HK\$3.88.
- (d) In the event that the aggregate value of HKEC Shares (calculated at the rate of HK\$3.88 per HKEC Share) in respect of which holders of Stock Exchange Scheme Shares have elected to receive cash does not exceed the Stock Exchange Cash Limit, each such holder will be entitled to receive payment at the rate of HK\$3.88 for every HKEC Share specified in his Form(s) of Election.
5. Not less than 14 days before the Election Deadline, the Stock Exchange shall notify the holders of Stock Exchange Scheme Shares of the Election Deadline in writing by posting such notice in pre-paid envelopes to such holders at their respective addresses appearing in the register of members of the Stock Exchange at the close of business on the day immediately preceding the day of posting.
6. (a) To be valid, a Form of Election shall be properly completed and signed in accordance with the instructions appearing thereon by the holder of Stock Exchange Scheme Shares to which it relates and shall be received by the Stock Exchange at its registered office by not later than the Election Deadline.
- (b) An election once made shall be irrevocable.
- (c) HKEC shall have the right to reject any or all Forms of Election it determines not to be valid. HKEC reserves the right to treat any Form of Election which has been completed incorrectly in any manner which (at its absolute discretion) is not material as being valid.
7. For the purpose of enabling HKEC to discharge its obligations pursuant to Clause 4 of this Stock Exchange Scheme and under the Futures Exchange Scheme, the Stock Exchange shall lend to HKEC a sum not exceeding HK\$669,000,000 subject and pursuant to the terms of a funding document entered into between HKEC and the Stock Exchange on 30th July, 1999.

SCHEME OF ARRANGEMENT

PART V

Allotments and Issues and Payments

8. Not later than 10 days after the Effective Date, HKEC shall effect, as of the Effective Date, the allotment and issue of the HKEC Shares pursuant to Clause 3 of this Stock Exchange Scheme and shall effect the payments, if any, pursuant to Clause 4 of this Stock Exchange Scheme.
9. (a) Not later than 10 days after the Effective Date, HKEC shall deliver or procure to be delivered the certificates for the HKEC Shares allotted and issued and the cheques in respect of the cash payments effected in accordance with Clause 8 of this Stock Exchange Scheme to the persons to whom the HKEC Shares shall have been respectively so allotted and issued or the payments shall have been respectively made, as the case may be, by sending such certificates and cheques through the post in pre-paid envelopes addressed to such persons at their respective addresses appearing in the register of members of the Stock Exchange at the close of business on the Record Date.

(b) All cheques shall be made payable to the order of the person or persons to whom in accordance with paragraph (a) of this Clause 9 the envelope containing the same is addressed and the encashment of any such cheque shall be a complete discharge to HKEC for the moneys represented thereby.

(c) All certificates and cheques shall be posted at the risk of the addressees and neither HKEC nor the Stock Exchange shall be responsible for any loss or delay in transmission.
10. All mandates or other instructions to the Stock Exchange in force at the close of business on the Record Date relating to a Stock Exchange Scheme Share shall with effect from the Effective Date, unless and until revoked or directed otherwise by a holder in writing to HKEC, be deemed to be valid and subsisting mandates or instructions to HKEC in respect of the corresponding HKEC Shares to be allotted and issued pursuant to this Stock Exchange Scheme.
11. As from the Effective Date all existing certificates representing holdings of Stock Exchange Scheme Shares as at the close of business on the Record Date shall cease to have effect for any purposes and every holder thereof shall be bound on the request of HKEC to deliver up to HKEC the certificate(s) for his holding(s).
12. This Stock Exchange Scheme shall become effective as soon as an office copy of the Order of the Court sanctioning this Stock Exchange Scheme under section 166 of the Companies Ordinance and confirming, under section 60 of the Companies Ordinance, the reduction of share capital provided for by this Stock Exchange Scheme, together with a minute relating to the share capital of the Stock Exchange and containing the particulars required by section 61 of the Companies Ordinance, shall have been delivered to and registered by the Registrar of Companies, but such office copy and minute shall not be delivered for registration unless and until an office copy of the Order of the Court sanctioning the Futures Exchange Scheme, together with a minute relating to the share capital of the Futures Exchange, shall be so delivered at the same time.

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13. Unless this Stock Exchange Scheme shall have become effective on or before 31st March, 2000 or such later date, if any, as the Court may allow, this Stock Exchange Scheme shall lapse.
14. The Stock Exchange and HKEC may jointly consent for and on behalf of all concerned to any modification of or addition to this Stock Exchange Scheme or to any condition which the Court may think fit to approve or impose.
15. All costs, charges and expenses of and incidental to this Stock Exchange Scheme and the costs of carrying the same into effect shall be borne by the Stock Exchange save that HKEC shall bear its own costs, charges and expenses in connection with this Stock Exchange Scheme.

Dated 3rd September, 1999

NOTICE OF COURT MEETING

HCMP 5122/99

**IN THE HIGH COURT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION
COURT OF FIRST INSTANCE
MISCELLANEOUS PROCEEDINGS NO. 5122 OF 1999**

IN THE MATTER

of

THE STOCK EXCHANGE OF HONG KONG LIMITED

and

IN THE MATTER

of

THE COMPANIES ORDINANCE, CHAPTER 32 OF THE LAWS OF HONG KONG

NOTICE OF MEETING

NOTICE IS HEREBY GIVEN that, by an Order dated 1st September, 1999 made in the above matters, the Court has directed a Meeting to be convened of the holders of "A" shares of HK\$1.00 each ("Shareholders") in the capital of The Stock Exchange of Hong Kong Limited (the "Stock Exchange") for the purpose of considering and, if thought fit, approving (with or without modification) a *Scheme of Arrangement proposed to be made between the Stock Exchange and the Shareholders* and that such Meeting will be held at 1st Floor, One and Two Exchange Square, Central, Hong Kong on Monday, 27th September, 1999 at 4:30 p.m. at which place and time all Shareholders are requested to attend.

A copy of the Scheme of Arrangement and a copy of the Explanatory Statement required to be furnished pursuant to Section 166A of the above-mentioned Ordinance are incorporated in the document of which this Notice forms part.

NOTICE OF COURT MEETING

By the Order dated 1st September, 1999, the Court has further directed that notwithstanding the provisions of the Articles of Association of the Stock Exchange, all Shareholders whose voting rights have been suspended in accordance with such Articles of Association be eligible to attend and vote at the Meeting in person or by proxy, or by their personal representatives, trustees in bankruptcy, provisional liquidators or liquidators, or other lawful representatives, as the case may be, attending and voting either in person or by proxy, subject to the production at the Meeting of evidence satisfactory to the Chairman thereof of the capacity in which and authority by which any person claiming to act as the lawful representative of any Shareholder whose voting rights have been suspended as aforesaid is entitled so to act.

Shareholders including those whose voting rights have been suspended as mentioned above or their lawful representatives may vote in person at the Meeting or they may appoint another person, whether a Shareholder or not, as their proxy to attend and vote in their stead.

A pink form of proxy for use at the Meeting is enclosed herewith.

It is requested that forms appointing proxies be lodged at the registered office of the Stock Exchange, 1st Floor, One and Two Exchange Square, Central, Hong Kong not less than 48 hours before the time appointed for the Meeting, but if forms are not so lodged they may be handed to the Chairman of the Meeting at the Meeting.

By the same Order, the Court has appointed Lee Hon Chiu, the Chairman of the Stock Exchange, or, failing him, Seto Gin Chung, John, a Vice Chairman of the Stock Exchange, or, failing him, Hui Chiu Chung, Stephen, a Vice Chairman of the Stock Exchange, to act as Chairman of the Meeting and has directed the Chairman to report the result thereof to the Court.

The Scheme of Arrangement will be subject to the subsequent approval of the Court.

LINKLATERS
10th Floor
Alexandra House
Hong Kong
Solicitors to

THE STOCK EXCHANGE OF HONG KONG LIMITED

Dated 3rd September, 1999

NOTICE OF EXTRAORDINARY GENERAL MEETING

THE STOCK EXCHANGE OF HONG KONG LIMITED

NOTICE IS HEREBY GIVEN that an Extraordinary General Meeting of The Stock Exchange of Hong Kong Limited (the "Stock Exchange") will be held at 1st Floor, One and Two Exchange Square, Central, Hong Kong on Monday, 27th September, 1999 at 4:45 p.m. (or so soon thereafter as the Meeting of the holders of "A" shares of HK\$1.00 each in the capital of the Stock Exchange ("Shareholders") convened by direction of the High Court of the Hong Kong Special Administrative Region for the same place and day shall have been concluded or adjourned) for the purpose of considering and, if thought fit, passing the following resolutions which will be proposed as Special Resolutions. Each of Special Resolutions Nos. 2, 3, 4 and 5 will only be proposed for approval by Shareholders if Special Resolution No. 1 shall have been passed:

SPECIAL RESOLUTION NO. 1

"THAT

- (A) the Scheme of Arrangement (the "Stock Exchange Scheme") dated 3rd September, 1999 between The Stock Exchange of Hong Kong Limited (the "Stock Exchange") and holders of Stock Exchange Scheme Shares (as defined in the Stock Exchange Scheme) in the form of the print contained in a composite document which has been produced to this Meeting, and for the purpose of identification marked "A" and signed by the Chairman hereof, with any modifications thereof or additions thereto or subject to any conditions approved or imposed by the High Court of the Hong Kong Special Administrative Region, be and the same is hereby approved;
- (B) for the purpose of giving effect to the Stock Exchange Scheme:
- (i) on the Effective Date (as defined in the Stock Exchange Scheme) the authorised and issued share capital of the Stock Exchange be reduced by cancelling and extinguishing the Stock Exchange Scheme Shares;
 - (ii) subject to and forthwith upon such reduction of capital taking effect, the authorised share capital of the Stock Exchange be increased to its former amount of HK\$1,200 by the creation of such number of new "A" shares of HK\$1.00 each as is equal to the number of the Stock Exchange Scheme Shares cancelled; and
 - (iii) the Stock Exchange shall apply the amount of the credit arising in its books of account as a result of the reduction of share capital in paying up in full at par the new "A" shares of HK\$1.00 each to be created as aforesaid, which new "A" shares shall be allotted and issued, credited as fully paid, to Hong Kong Exchanges and Clearing Limited and its nominee and the Council be and is hereby unconditionally authorised to allot and issue the same accordingly."

NOTICE OF EXTRAORDINARY GENERAL MEETING

SPECIAL RESOLUTION NO. 2

“THAT, subject to the approval of the Securities and Futures Commission, the Articles of Association of The Stock Exchange of Hong Kong Limited be and are hereby amended by adding the following new Article 86A immediately after the existing Article 86:

- “86A (a) Notwithstanding any other provision of these Articles, all members of the Council shall be entitled to remain in office until the day on which the scheme of arrangement dated 3rd September, 1999 under section 166 of the Companies Ordinance, Chapter 32 of the Laws of Hong Kong (the “Scheme”) pursuant to which the Exchange will become a wholly owned subsidiary of Hong Kong Exchanges and Clearing Limited becomes effective (the “Effective Date”). For the avoidance of doubt, no election of members of the Council shall take place at the 1999 Annual General Meeting of the Exchange and all provisions in these Articles regarding constitution of the Council, maximum years of service of members of the Council, election of members of the Council at Annual General Meeting and the relating nomination, election and voting requirements and procedures shall cease to apply.
- (b) Notwithstanding any other provision of these Articles, the Chairman and the Vice-Chairmen shall be entitled to remain in office until the Effective Date and the election requirement and procedures in Article 91 shall cease to apply.
- (c) All members of the Nominating Committee shall be entitled to remain in office until the Effective Date and the provisions regarding maximum years of service of members of the Nominating Committee in Article 95A shall cease to apply. No election of the Chairman of the Nominating Committee shall take place after the 1999 Annual General Meeting of the Exchange. The Chairman of the Nominating Committee shall be entitled to remain in office until the Effective Date and the election requirement in Article 95A(e) shall cease to apply.
- (d) In the event that the Scheme does not become effective on or before 31st March, 2000 or such other date as the High Court of the Hong Kong Special Administrative Region may allow, all members of the Council and Nominating Committee and the Chairman and Vice Chairmen of the Stock Exchange shall be entitled to remain in office until the 2000 Annual General Meeting.”

NOTICE OF EXTRAORDINARY GENERAL MEETING

SPECIAL RESOLUTION NO. 3

“THAT, subject to the approval of the Securities and Futures Commission, the objects clause in Clause 3 of the Memorandum of Association of The Stock Exchange of Hong Kong Limited be and is hereby amended by inserting the following paragraph at the end of Clause 3:

“and it is declared that

- (a) this clause shall be interpreted in the widest and most general manner and without regard to the *ejusdem generis* rule or any other restrictive principle of interpretation;
- (b) each of the subclauses of this clause shall, unless it expressly provides to the contrary, be deemed to set out a separate, distinct and independent object of the Exchange and not a power ancillary or incidental to the objects set out in any other subclause;
- (c) each of those subclauses shall be without prejudice to, or to the generality of, any other subclause and shall be in no way limited or restricted by reference to or inference from any other subclause.”

SPECIAL RESOLUTION NO. 4

“THAT, subject to the approval of the Securities and Futures Commission, with effect from the *Effective Date* (as defined in the Scheme of Arrangement dated 3rd September, 1999 between The Stock Exchange of Hong Kong Limited and holders of ‘A’ shares) the provisions contained in the printed document produced to this Meeting, and for the purpose of identification marked “B” and signed by the Chairman hereof, be and are hereby approved and adopted as the new Clause 3 and the new Clause 5 in the Memorandum of Association of The Stock Exchange of Hong Kong Limited in substitution for and to the exclusion of the existing Clause 3 and the existing Clause 5.”

SPECIAL RESOLUTION NO. 5

“THAT, subject to the approval of the Securities and Futures Commission, with effect from the *Effective Date* (as defined in the Scheme of Arrangement dated 3rd September, 1999 between The Stock Exchange of Hong Kong Limited and holders of ‘A’ shares) the Articles of Association contained in the printed document produced to this Meeting, and for the purpose of identification marked “C” and signed by the Chairman hereof, be and are hereby approved and adopted as the Articles of Association of The Stock Exchange of Hong Kong Limited in substitution for and to the exclusion of all the existing Articles of Association.”

Registered office:

1st Floor, One and Two Exchange Square
Central
Hong Kong

NOTICE OF EXTRAORDINARY GENERAL MEETING

Explanatory Notes to Special Resolutions

- 1 *The purpose of Special Resolution No. 1 is to give effect to the Stock Exchange Scheme.*
- 2 *The purpose of Special Resolution No. 2 is to dispense with the requirement to carry out the election process for the Council at the 1999 Annual General Meeting of the Stock Exchange and that all members of the Council and Nominating Committee and the Chairman and Vice Chairmen of the Stock Exchange may remain in office pending the Stock Exchange Scheme taking effect.*
- 3 *The purpose of Special Resolution No. 3 is to amend the objects clause in the Memorandum of Association of the Stock Exchange to give wider powers to the Council, in particular to enable the power to make loans set out in Clause 3(28) of the Memorandum of Association to be exercised in a wider range of circumstances.*
- 4 *The purpose of Special Resolution No. 4 is to amend, effective upon the Stock Exchange becoming a wholly owned subsidiary of Hong Kong Exchanges and Clearing Limited ("HKEC"), the objects clause in the Memorandum of Association of the Stock Exchange to enable the Stock Exchange to pay dividends to its shareholders and to make consequential amendments to the objects clause such as substituting references to "exchange participants" for references to "members". The Memorandum of Association as so amended is enclosed with this document.*
- 5 *The purpose of Special Resolution No. 5 is to adopt a new set of Articles of Association of the Stock Exchange to be effective upon the Stock Exchange becoming a wholly owned subsidiary of HKEC. The new Articles of Association reflect the fact that shares in the Stock Exchange will no longer be held by the persons trading on the Stock Exchange and, instead, the Stock Exchange will be a wholly owned subsidiary of HKEC. The new Articles of Association are enclosed with this document.*

NOTICE OF EXTRAORDINARY GENERAL MEETING

Notes:

- (i) A Shareholder entitled to attend and vote at the Meeting is entitled to appoint a proxy to attend and vote instead of him. A proxy may only vote on a poll and not on a show of hands. A proxy need not be a Shareholder.
- (ii) A white form of proxy for use at the Meeting is enclosed herewith. The completion and return of a white form of proxy will not preclude a Shareholder from attending the Meeting and voting in person. In that event, his form of proxy will be deemed to have been revoked.
- (iii) In order to be valid, forms appointing proxies must be lodged at the Stock Exchange's registered office not less than 48 hours before the time appointed for holding the Meeting or any adjournment thereof.
- (iv) A copy of each of (a) the proposed amended Memorandum and Articles of Association of the Stock Exchange that will take effect immediately as referred to respectively in Special Resolutions No. 2 and 3; and (b) the proposed amended Memorandum of Association and new Articles of Association of the Stock Exchange that will take effect upon the Scheme of Arrangement becoming effective and as referred to respectively in Special Resolutions No. 4 and 5 are available for inspection during normal office hours at the registered office of the Stock Exchange and at the Meeting.

By Order of the Board
Tsang Chiu Wan
Company Secretary

Dated 3rd September, 1999