創新科技署
Innovation and Technology Commission
香港特別行政區政府
The Government of the Hong Kong Special Administrative Region

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19 May 2004

Ms Miranda Hon
Clerk
Public Accounts Committee
Legislative Council
Legislative Council Building
8 Jackson Road, Central, Hong Kong

Dear Ms Hon,

The Director of Audit's Report on the results of value for money audits (Report No. 42)

Chapter 2 : Funding of projects under the Applied Research Fund

Thank you for your letter dated 11 May 2004.

We attach the requested information in seriatim herewith for your reference, please. Please note that some of the specifics, such as individual names of companies or persons, have been blotted in view of commercial sensitivity. We have also highlighted information, such as fee levels or specific terms of management agreement, which may be particularly commercially sensitive. We should be grateful if you would treat the information with due care.

Yours sincerely,

(Tony Lam)
for Commissioner for Innovation and Technology

cc Secretary for Commerce, Industry and Technology

Secretary for Financial Services and the Treasury
(Attn : Mr Manfred Wong)

Director of Audit

****Note by Clerk, PAC:*** *Item (c) not attached.*

(a) General investment return duration of venture capital

- Venture capital has been developed in the U.S. for more than three decades and the U.S. is a very well-developed market.

- If we use the U.S. as a benchmark and in accordance with studies of U.S. venture capital market, it shows that "... nearly half of all venture capital-backed companies don't fulfill their potential, and nearly one-third go out of business"[1].

- According to the information of the National Venture Capital Association of the U.S., an early stage investment may take "seven to ten years to mature" while later stage investment may take "a few years". It has also pointed out that, generally, venture funds have a life span on average of "10 to 12 years".

- Separately, academics of the U.S. have also pointed out that the median age of technology-based companies making use of initial public offering as a means for divestment and recouping return has recently been gradually increased to some nine years in 2001-02 from being about four years in 1999-2000 (during which many were just 18 months)[2]. This has reflected that the investment return duration of venture capital has been significantly lengthened in recent years.

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1 Source : "The Money of Invention: How Venture Capital Creates New Wealth", by Paul A Goupers and Josh Lerner, Harvard Business School Press, pg. 28.

2 Source : "USA Today" (a national U.S. newspaper) dated 12 April 2003, quoting Professor Jay Ritter, University of Florida.

(b) Report No. 42 of the Director of Audit Chapter 2: Funding of Projects Under the Applied Research Fund (ARF)

- The statistics provided in paragraph 2.7(a) to (e) of the Audit Report are currently updated as at 31 December 2003 as follows:

  (a) as at 31 December 2003, the valuation of the 23 investments managed by fund managers was $157.6 million, representing 44% of the investment at cost. Six of these investee companies were liquidated or sold at nominal value.

  (b) among the remaining 17 active investments, one was listed on the Growth Enterprise Market in May 2002. Another was acquired in February 2000 by a company listed on the Hong Kong Stock Exchange and four had won prestigious technology awards either locally or overseas. One other company was acquired in April 2004 by a company listed on NASDAQ.

  (c) as at 31 December 2002, the then 16 active investee companies attracted investments amounting to $870 million other than those from the ARF. As at end March 2004, the ARF further attracted $7.5 million co-investments. Together with the $870 million reported, the existing total amount of co-investments was about $877.5 million, which was 1% higher than the figure ($870 million) as end December 2002. This represents a multiplier factor of 2.9 against the corresponding ARF's investment.

  (d) 14 investee companies were small-and-medium-sized enterprises with less than 50 employees at the time of ARF's initial investment. As at end December 2003, 3 were beyond this employment level.

  (e) After the engagement of fund managers, the ARC approved investments into 23 cases with approved funding of $378 million. This approved amount is higher than the $97 million funding approved for the 27 cases managed by the former Industry Department by about 3.9 times. More importantly, the institutional arrangements of engaging fund managers since November 1998 have much improved the then limitations in managing the funding scheme by the former Industry Department staffed by civil servants : more proactive ability to identify projects; better commercial sense and expertise in assessment; predominance of funding through equity participation instead of straight loans, more active project management and participation; more adequate expertise in arranging investment exit. Furthermore, the professional fund managers have enabled the ARC to better support the investee companies in that they could provide better networking advantages, as well as technical, management and marketing expertise, thereby enhancing the technical and commercial viability of approved projects. These contributions are essential and have an impact, albeit difficult to quantify.

(d) Venture capital in the market versus Applied Research Fund

- We would like to point out that while some market statistics are available (e.g. the size of Hong Kong's venture capital investment portfolio; Hong Kong's disbursements by financing stage; disbursements to Hong Kong's companies, etc.), they need to be treated with caution in that the degree of precision of these figures is very much affected by the lack of precision on what constitutes "Hong Kong's venture capital" or "Hong Kong companies".

- Unlike the ARF which may only be invested in technology venture / R&D projects that have commercial potentials and that must have substantial connections to Hong Kong, Hong Kong's venture capital may invest in "Hong Kong companies" outside Hong Kong.

- Taking into account the above argument, we consider that the figures presented below need to be interpreted with due care.

- As far as we are aware, industry statistics have shown that the venture capital investment portfolio in Hong Kong was US$10,817 million as at end 2002.[1]

- However, industry sources have also shown that only about 11% was disbursed to "Hong Kong companies".[2]

- Industry statistics have also shown that about 46% was disbursed to industries more closely related to technology, such as computer-related industries, electronics, information technology, medical / biotechnology and telecommunications industries.[3]

- On the above basis, the investment portfolio into "Hong Kong companies" in technology-related industries was about US$547 million[4] as at end 2002. That of the ARF was about US$29.6 million as at end 2002[5].

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1 Source : Asian Private Equity 300 (15th Edition) : The 2004 Guide to Venture Capital in Asia
2 Source : The 2003 Guide to Venture Capital in Asia. The figure is with respect to year 2001.
3 Source : The 2003 Guide to Venture Capital in Asia. The figure is with respect to year 2001.
4 US$547 million = US$10,817 million x 11% x 46%. We have applied the figures of 11% and 46% for the year 2001 in this calculation as corresponding figures for 2002 are not yet available.
5 Source : See paragraph 2.7(a) of the Audit report, which quotes that the valuation of 21 investments

- The percentage of ARF investments relative to the overall total is thus about 5.4%[6].

- While the figure of 5.4% may seem to imply that ARF investments occupy only a limited share of the venture capital invested in technology-related companies, we would like to point out that, according to industry statistics, only about 23% of the venture capital disbursements of Hong Kong is for companies at seed-stage or start-up stage[7] in which ARF investments mostly focus on and during which venture capital support by public sector fund like ARF would be most critical and useful to augment any funding support from other sources.

- It therefore follows that if we further qualify the aforementioned figures by the relevant stage of financing in which ARF investments mostly focus on, the investment portfolio into Hong Kong companies in technology-related industries in seed-stage or start-up stage might be about US$126 million[8] as at end 2002. This translates into ARF investments being about 23%[9] of the relevant venture capital investment portfolio in technology-related industries in Hong Kong companies at the seed or start-up stage.

END

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managed by fund managers was HK$231 million as at 31 December 2002.

6 5.4% = US$29.6 million / US$547 million x 100%

7 Source : The 2003 Guide to Venture Capital in Asia. This figure is with respect to year 2001.

8 US$126 million = US$547 million x 23%. We have applied the figure of 23% for the year 2001 in this calculation as the corresponding figure for 2002 are not yet available.

9 23% = US$29.6 million / US$126 million x 100%

(e) Six most successful investment projects managed by the fund managers

- We have attached some details of six most successful investment projects managed by the fund managers.

- It is difficult to project when ARF investments may be exited or whether such investments may bring return to ARF. Many factors would affect the timing and outcome of exit from these investments, such as business cycle, financial market situation, performance of the technology market and the global economic trend.

- As stated in our reply to part (a), the median age of technology-based companies matured for initial public offering, which is an important way for exiting venture capital investments, has recently been lengthened to some nine years. The ARC has, however, already stipulated in its relevant management agreements that the fund managers shall use their reasonable endeavours to ensure that all of their investments are realized not later than the date of expiration of the management agreements, which will stay in force until 2007-08 as pointed out in paragraph 3.6 of the Audit report.

Applied Research Fund

Six Most Successful Cases

Case A

- The fund manager proposed the Applied Research Council (ARC) to invest in Company A in November 1998. The investment was considered to be in line with the public mission of the Applied Research Fund (ARF).

- Company A was a network equipment distributor when ARC invested in the company.

- With the investment of ARC in 1998, Company A has successfully transformed into a network infrastructure integrated system provider and has developed formidable research and development (R&D) capability in network software.

- Company A was listed on the Growth Enterprise Market (GEM) on 17 May 2002. It is the first publicly listed ARC investee company. The accomplishment of initial public offering is generally considered as an important milestone in venture capital investment.

- Company A is currently seeking to develop a "New Generation Network" to integrate the transfer of voice, data and graphics in one network. This has the potential of creating a new model for the future communications industry.

- ARC invested a total of $46.7 million in Company A. $30.4 million has been recouped.

Case B

- The fund manager proposed the ARC to invest in Company B in November 1998. The investment was considered to be in line with the public mission of the ARF.

- Company B engages in the provision of services in real-time financial quote system and securities exchange system so that investors can obtain financial information, such as information of listed companies, the Hang Seng Index and index futures, share price quotes, and Chinese and English financial news and commentaries, via the Internet and leased line connections.

- In February 2000, Company B was acquired by another company listed on the Hong Kong Stock Exchange which engaged in the sales of pagers, information devices and financial information services. The acquisition of an investee company by a listed company is generally considered as an important milestone in venture capital investment.

- The amount approved by the ARC for this investment is $8 million.

Case C

- The fund manager proposed the ARC to invest in Company C in March 1999. The investment was considered to be in line with the public mission of the ARF.

- Company C engaged in the development of software tools for enhancing database performance.

- Company C won the IT Excellence Awards - Gold Award for Product organized by the Hong Kong Computer Society in 1999 and the Hong Kong Award for Industry - Technological Achievement Award in 2000. It is also the first-ever non-US company winning the "National Business Incubation Association Award - Graduate of the Year" in 2000.

- In April 2004, Company C was acquired by a listed company on NASDAQ of the U.S.. That U.S. company engages primarily in the development and sales of a range of software tools to optimize the performance of application software and database. The turnover of that company was about US$300 million and its market capitalization was about US$1.2 billion. Upon acquisition, the U.S. company plans to focus part of its R&D work in database software in Hong Kong.

- Company C received a total of $24.59 million investment from the ARC.

Case D

- The fund manager proposed the ARC to invest in Company D in December 1998. The investment was considered to be in line with the public mission of the ARF.

- Company D engages in the development of speech recognition system.

- In 1999 when ARC invested in the company, the then annual business turnover of Company D was about US$650,000. As at December 2003, Company D's business turnover for 2003 increased to about US$1.3 million.

- Company D is a provider of conversational speech recognition technology. Its technology in speech recognition system has won the Singapore National Infocomm Awards 2001/02 and also the Asia Pacific Information and Communications Technology Awards 2001.

- These awards are recognition of Company D's innovation and contribution in international speech technology areas, and affirmation of its position in the market.

- Company D received a total of $24.16 million investment from the ARC.

Case E

- The fund manager proposed the ARC to invest in Company E in August 2002. The investment was considered to be in line with the public mission of the ARF.

- Company E engages in the research of tests concerning the genotype materials in human plasma. The plasma genotype information is valuable to tests and diagnoses for cancers, prenatal diseases and other diseases. For instance, the technology developed by Company E provides a non-invasive method for the detection of prenatal diseases of the fetus.

- Company E's technology is originated from R&D work carried out by a university. At present, Company E is engaging in the development of diagnoses and tests for congenital and other cancers. Company E is an investment example demonstrating how the ARF assists in the commercialization of research results of universities. When ARC invested in Company E, the company's turnover was about HK$850,000. In 2003, its turnover was about HK$1.80 million.

- The amount approved by the ARC for this investment is $11.7 million.

Case F

- The fund manager proposed the ARC to invest in Company F in July 1999. The investment was considered to be in line with the public mission of the ARF.

- Company F was a technology-based venture originating from a local university. It engages in electronic aggregation and distribution of Chinese language-based content. Since the injection of ARC's investment, Company F's business turnover has increased by some 40 times from $690,000 to about $28 million in 2003. Its Chinese digital press cutting service is also very popular.

- Company F is an investment example demonstrating how the ARF assists the commercialization of R&D results of universities.

- Company F received $33.84 million funding from the ARC.

(f) Minutes of meeting of the Applied Research Council (ARC) held on 15 September 2000 related to Case A

(b)

9. pointed out that two investee companies managed by ı were experiencing difficulties. They were I and ə and the details had been set out in the covering paper. She drew Directors' attention that that the Council had lost a total of $23 million in Besides, ʼı had proposed to sell off the Council's shares in as soon as practicable and this could mean another loss of $12 million. commented that those were serious cases and Directors might wish to gather more information from representative and decide whether any actions would be needed.

[of attended the meeting for this item]

10. _____ briefly reported to the Directors the latest position of the investee companies managed by

11. Directors asked for more information on the three problematic cases, i.e. ı, ' and On , Directors asked the details of the market change that had caused a failure of the company and how had come to the conclusion that we should sell the company. Directors further asked why was willing to buy if the company had no future as commented by ı. Moreover, Directors considered that even if the Council did not sell our shares, it would not make any difference to the Council in terms of liability and financial outcome, i.e. the Council would lose all our investments in the company. Besides, Directors asked why had not provided any details to the Council before or after that major decision to sell the Council's shares. ____ said that she had not been involved in the handling of this case personally and therefore did not know the answers to such detailed questions. But, she remarked that the situation for had developed in a very short period of time and it had not been possible for them to inform the Council beforehand.

12. On , Directors asked why 1 had held back their decision in investing in the company. Directors also asked why had valued the Council's shares in this company at zero and would like to know whether / 'ı was very pessimistic about the situation. explained that a new business model was being tried out in this company and would only sell the Council's shares if the new model was not working. In the meantime, had to be cautious and had therefore valued the Council's shares at zero.

13. On , Directors asked why the company required as much money as $90 million to support its activities from end June to end 2000. undertook to check and revert.

14. also asked for clearer information on the calculations of internal rates of return.

15. In response to question on what had learned from those problematic cases, indicated that the lesson for them was that they would have to monitor the spending of their investee companies more closely. remarked that it was a surprise to him that , which was such a well-established company, still needed to go through such experience to 'learn' this lesson.

16. In response to question on whether had any new investment plans in the near future, indicated that there was nothing concrete at the moment. asked whether Executive Director of would be available to give a more detailed account of the events to the Council. indicated that would be back to Hong Kong the following Wednesday. suggested and Directors agreed that should withhold all new investments until the Council had been provided with details of the problematic cases and were satisfied with the explanations.

[left the meeting.]

17. Directors were very concerned with the three problematic cases and that the Council had not been consulted or informed of the major decisions (such as selling our shares in) in a timely manner. clarified that the agreement provided the fund manager with the full discretion to make any changes to the investments so long as

the public mission was not affected. But, she also found it highly undesirable that did not inform the Council or even the of the incident immediately after their major decision about had only come to know the incident when she was reading the normal quarterly report. She further disclosed that unlike other fund managers, maintained little day to day contacts with the Secretariat. also pointed out that he had gathered from the newspapers that had moved its operation to the USA and this appeared to be in breach of the public mission. Besides, pointed out that while mentioned in their report that the Council had only invested $16 million in , the Council had indeed invested a total of $24 million.

18. also pointed out that the quality of work was not satisfactory. For example, the financial reports of some investee companies in quarterly reports contained so little information that it was hardly useful to the Directors.

19. considered that we now had a prima facie case for possible breach of the Council's trust on and the Council should intervene despite the agreement provided for much discretion to fund managers. He suggested and some Directors agreed that the Council might have to consider requesting to seek the Council's prior approval before making any major decisions such as buying or selling shares. also considered that we might need to make it a condition for our fund managers that the Council should only put in our investments until all the other co-investors had done so.

20. Directors agreed that the situation was serious and that should be asked to submit a detailed report on the three problematic cases in three weeks' time. An emergency meeting should be held with presence to discuss the detailed reports in one month's time. Until and unless the Council was satisfied with explanations, should not be allowed to make any new investments. Directors also requested that the Secretariat provide background papers on how the three cases had been approved in the first instance.

(Action :)

21. While Directors recalled that when our fund managers were appointed, was supposed to assume the more risky businesses while was more on traditional technology companies, asked whether we should revise our guidelines for the fund managers so

as to prescribe the level of risks that our fund managers could take on.

22. suggested and <u>Directors</u> agreed that the Secretariat write to pointing out the problems and that the Council was not satisfied with its performance. The Secretariat should take a fairly firm position.

(f) Minutes of meeting of the Applied Research Council (ARC) held on 30 October 2000 related to Case A

briefed the Directors on the purpose of this emergency meeting. At the last meeting in September, the Directors noticed that three investee companies managed by had experienced difficulties. However, the representative of was not able to provide satisfactory explanations to the Directors. Therefore, it was decided that , Executive Director of , should come for an emergency meeting to explain the details to the Directors.

2. commented that it was obvious that was not performing a proper monitoring work. He invited the Directors to exchange ideas on what questions to ask before inviting him to join the meeting.

3. said that the mission of ARF was to fund Hong Kong-based technology start-ups. Taking as an example, the company had invested little in technology development and he was not sure why funding had been approved for this type of company. He also asked whether the marketing activities, which was strictly speaking not related to technology development, should be funded. explained that the original ambit of the Council was to fund R&D activities in the manufacturing sectors. But, given the change in our economic structure, starting from 1998-99, internet-based companies had also been considered. After the appointment of fund managers, the focus of the ARF was on the whole portfolio of investments. So, human resources development and marketing were also supported. added that it was true that focused on investing dotcom companies and it seemed to him that the most important concern for ARC at the moment was the monitoring of the remaining investee companies managed by

4. pointed out that the most unsatisfactory point was this Council had not been kept informed in a timely manner. reported that had admitted that had not been communicating well with the Council. said that the Directors might also ask for account statements or audit reports of to see if the company was still in a sound financial position as might have also invested into the three problematic companies.

attended the meeting]

5. admitted that there had been a lack of communication between his Company and the Council but he stressed that things had been moving very fast. On explained that it had also been a hard time for They evaluated the company as the superstar of their portfolio especially when and had also invested in They had planned to list the company in March – June 2000. He admitted that as they evaluated the company positively, they allowed it to spend ahead of time and it had proved to be a wrong bet.

6. asked when had first discovered the problem. replied that it was March – April 2000 when the revenue had been flattening out. However, at that time their investment evaluation had mainly been on the technology but not the revenue. Moreover, it was quite beyond the expectation of Board that the Company had to spend around US$3 million to settle a legal and accounting bill relating to an acquisition. asked whether the Council had been put in a similar position as the other investors of replied that all investors had been treated equally.

7. On said that had signed agreements with and and everything had been fine. But the two companies had not kept their promise to invest into had been talking to the lawyers to sue the two companies concerned. asked when sensed that there might have been some troubles. replied that it was in March 2000 when dragged on their investments for three to four months and suggested putting in shares and services instead. In response to s query, had also explained briefly the reasons that he had gathered as to why had changed so suddenly.

8. On said that the company was doing well in developing convenient internet plugs for the hotel industry. They had managed to obtain master contracts with major hotel groups. However, the time needed to raise funds had been longer than expected and the company was running out of cash. The company was at the risk of not being able to honour their commitments in the contracts. Therefore, would propose to the Council to inject bridge loan at the third round financing for shortly.

9. noted from the latest figures of that the revenue for the company was so low that the company would not be able to pay off their investments. He was worried that when 3G came, the entire investment would be totally wasted. He therefore did not consider that the company was in a financial healthy situation. further asked if the Council could sell its shares to other investors with some discount. replied that it was possible but would probably hurt the company since other investors would lose confidence in the company. asked about the chance for other investors to invest if ARC invested in the third round financing. replied that ARC was the largest investor at the moment and another existing shareholder had indicated that they would also invest about HK$8 million. Other new investors like would put in money.

10. asked about the minimum amount of money that would be needed to be invested in before the company could become viable. replied that it would need about $234 million to complete the next round of financing. When asked by indicated that he was reasonably confident that the $234 million would be forthcoming. In particular, the financing was overseen by which had never failed though he admitted that nothing had been signed at the moment.

11. asked why the company needed so much money for bridge financing. replied that the company had all along run on a minimal subsistence level and it was not installing new hotel rooms. The company was running the danger of violating their contracts with the hotels. The company had also stopped sales and marketing activities. The bridge financing would be able to help the company to fulfill the minimum obligations.

12. commented that it was a sign of bad management as the company took on a very high burn rate before they were sure of the outcome of the next round of financing. commented that it would not be useful to provide just $2 million if it did not help the company to reach the critical point. responded that it was likely that the breakeven point would happen in April 2001. In response to responded that 's revenue in Q3 2000 was about $8-9 million because of the large number of hotels installed in March/April 2000. suggested spending more time to work on this proposal before submitting it to the Council.

13. asked if was happy with the management of

the ARC cases. ___ indicated that he was reasonably happy with the case. For , he considered that the Board was to be blamed. In response to 's question as to how much time spent on monitoring the cases, clarified that he did not travel much. He sat on the boards of five to seven investee companies and in particular on the boards for and The boards normally met on a monthly or quarterly basis. also got accounting staff to monitor the accounts and cashflow of the investee companies. They also got six investment staff in Hong Kong.

14. ________ asked for the current situation of other investments. On ______ replied that they managed to bring in investors from Beijing and it seemed that the company would soon be ready to go public. He considered that the company was substantially a profitable company and there was no need for new money at the moment. The problem was how to enable it to grow fast enough as the company had more projects than they could probably handle and they might need more money in future. At the moment, the company needed to conserve cash and be more prudent in their expansion plan. had been approached by a large system integrator for acquiring the entire company and the negotiations had started.

15. pointed out that it might be difficult for to penetrate the Mainland market. The majority of the banks there were happy with the proprietary products which were fine for day-to-day operations. He had also gathered that the CEO and most of the staff of had left the company and he was not sure whether the skills could be retained.

[left the meeting]

16. asked which investments considered to be the most successful. ________ replied that they were and (formerly known as) which had the best valuations.

17. As regards asked whether the Council could sell our shares. ______ said that we could but he was disappointed with and a proper listing might be done for later. On ________, ______ said that the company was growing slowly and was helping it to strengthen its sales and marketing by bringing in a sales director from and a marketing manager from

18. ____________ asked how would improve the situation in the future. said that they would tighten up the monitoring work. They had started to monitor and police the financial side of the investee companies four months ago. In the past, they just monitored the operation side. Moreover, they would not allow investee companies to spend aggressively as the ability to raise money could be seriously hampered by the market situations.

19. ________________ asked whether itself was involved in the problematic investments. said that for the fund called managed by , out of the fund size of US$ million, US$ million came from the staff and management of . This Fund had been able to yield a return which was more than the losses. As regards another fund called managed by , out of the fund size of US$ million, US$ million came from staff and management. At present, again, the return was more than the fund size.

20. ______ further asked how the communications between and the Council could be improved. He also requested for more frequent reports. __________ responded that they could prepare exceptional reports to the Council when there were major events such as writing off an investment, public offering or another round of financing. Also, as discussed with the , he could come to the ARC Board Meetings quarterly instead of half-yearly.

21. ______ requested that alert the Directors whenever there were irregularities even when the situation was fluid. They should provide a 2-3 page summary to the Secretariat who would then circulate it to the Directors. agreed and indicated that he would work out a proper format.

22. requested to have a tighter control on the financial situation of the investee companies and should provide the information to the Council on a regular basis. further requested that the financial information be presented in a way that was more easily understood by laymen and that the issues of interest to the management should be highlighted.

23. suggested to have a better support from his own company. When his colleague came to the meeting last time, she was not able to give proper answers to the questions raised.

[left the meeting]

24. commented that was a small firm with poor management. When the industry flourished, they were very busy in finding new investments but overlooked the monitoring work of the existing investments. further said that it was obvious that the reports on the problematic cases had just come too late.

25. said that for t, it had come to his knowledge that it had planned to go for IPO but had recently withdrawn and would turn to ARC for another round of financing. , said that it indicated that the company had no underwriter at the moment and it was a bad sign. He further added that he was not convinced of the business model of

26. asked if knew that the mission of ARC was to assist Hong Kong-technology companies but not to earn large sums of money. said that had not done anything wrong purely from a profit-making point of view. In response to some Directors' suggestion to maintain a tighter control over indicated that it was stated in our agreements with the Fund Managers that the Council would only comments on the public mission but not the revenue model of a proposed investment. said that the interpretation of public mission should give the Council sufficient leeway to comment on the proposals. But, opined that if the Council should only assess the public mission, Directors should not look at the investment details then. However, considered that it would be more prudent for Directors to raise objections to the proposed investments if we found anything wrong.

27. considered that the Council should now consider how to exercise control on and whether its new investments should be freezed. said that as bound by the Agreement with , the Council could not freeze any proposed investments put forward by However, a closer monitoring of its work was necessary. also added that the Council should be careful in handling the matter to avoid projecting a negative image on the Council.

28. After some discussions, it was agreed that a consensus would be needed from the Directors before any approval for new or follow-on investment proposal from was granted. If such a consensus could not be reached, an urgent meeting should be held to resolve the matter. Also, should come to the Board meeting quarterly.

asked that a letter be sent to informing him of the decision of the Council and urged him to improve communications with the Council in future.

(g)(i) Case A : whether and how co-investing proposal to resolve the conflict of interest declared in the Initial Investment Proposal was implemented and how should the co-investment provision of the relevant management agreements be enforced

System to deal with co-investment proposal and conflict of interest

- In terms of system and process, the management agreements provide that the fund managers may co-invest in any of the investments on their own account or on account of their other clients provided that such co-investment shall be made upon commercial terms which are comparable to those applicable to the investments.

- The management agreements also require that the fund managers shall not, among other things, invest the ARF in any investments already invested by any other funds managed by the fund managers concerned without the prior written consent and approval of the Council which shall not be unreasonably withheld.

- As regards making co-investment as a requirement, the three earlier management agreements concluded in November 1998 did not require co-investment as such. However, in the case of the fourth fund manager engaged by the ARC in March 2000, the relevant management agreement did make co-investment as a requirement.

- Through the management agreement, the ARC appoints the fund manager and the fund manager agrees to act as manager of the ARF in accordance with the terms of the management agreement.

- Under the relevant management agreement, the fund manager shall use its reasonable endeavours to act in the best interests of the Council in relation to the ARF and / or the investments.

- Also under the management agreement, the fund manager is granted the authority, power and right on behalf of, for the account of and in the name of the ARC to, among other things, purchase or otherwise acquire or sell, dispose of, exchange, vary or invest in the investments.

- The ARC-fund manager relationship is thus based on mutual good faith. The role of the ARC is to maintain a supervisory role and oversee the performance of the fund managers. The Council vests trust in its fund manager and does not micro-manage details of fund management.

<u>Case A</u>

- The relevant fund manager has declared, among other things, in its initial investment proposal in July 1999 that :

  (a) it wishes to resolve the conflict of interest by co-investing into Company A under the terms and conditions set by the third-party lead investor groups consisting of X and Y; and

  (b) it will not "participate in the negotiations of the terms and conditions by X and Y ...".

- By putting in co-investment from third party sources consisting of X and Y, it is a mechanism intended to resolve potential conflict of interest.

- By having the two third-party lead investor groups, X and Y, to negotiate the terms and conditions of investment, it is another step intended to resolve potential conflict of interest.

- With the above safeguards, the ARC Board did not cast any doubt on the proposed investment.

- In the relevant quarterly report for July-September 1999, the fund manager reported that "[i]n September, we (i.e. Fund Manager A) closed the investments in ... Company A ...".[1] In the quarterly report for October-December 1999, the fund manager reported that "[i]n September 1999, ARC completed its HK$16 million funding into Company A. X and

[1] Page 2 of the relevant quarterly report refers.

Y also invested HK$16 million each in the same round".[2] This showed that the co-investments from other sources were in place.

- The approved initial investment of HK$16 million by ARC into Company A resulted in 8.93% of shareholding in that company[3]. X and Y also held 8.93% each of Company A. The follow-on investment proposal of Case A also shows that X and Y each has 8.93% shareholding in Company A[4].

- The Audit report pointed out that another shareholder of Company A offered to take over the company and that the fund manager sold the ARC's shares in Company A at US$1.[5] In a quarterly report by the fund manager for April-June 2000 discussed by the ARC Board on 15 September 2000, the fund manager reported that the terms of purchase were the same for all shareholders[6]. According to the same quarterly report, the shareholder which took over Company A also offered to inject US$5 million into Company A to assume all responsibilities and liabilities in exchange for all the shares. At that time, Company A was still US$4 million in debt.[7]

- The public mission of the ARF is to spur local technology development through providing funding support to technology ventures and research and development projects that have commercial potential. Viewing from this perspective, if it is in the professional judgment of the fund manager of the then market situation for selling ARC's shares at nominal price to a buyer, the company and the personnel concerned would still have some further opportunities of development as opposed to putting the company in liquidation.

- There is no co-investment requirement in the management agreement for fund manager A.

- In cases where the fund manager has committed any material breach of any of the provisions of the management agreement or fail to perform and

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2 Page 9 of the relevant quarterly report refers.

3 See the 8.93% figure against ARC on page 3 of the follow-on investment proposal of Case A submitted to the Public Accounts Committee ("PAC") on 7 May 2004.

4 The names of X and Y were blotted in the version of the follow-on investment proposal of Case A submitted to PAC on 7 May 2004.

5 Item(j)(iii) on page 19 of the Audit report refers.

6 Page 9 of the relevant quarterly report refers.

7 ditto.

discharge any of its duties or obligations which are of a material nature, the ARC may terminate the management agreement.

- Concerning Case A, the ARC Board did not discern any criminal or fraudulent act but was concerned about the effectiveness of the fund manager. Action was taken to terminate the management agreement and the fund manager ceased to manage ARF on behalf of ARC in May 2002.

(g)(ii) Follow-up actions that have been and will be taken by the Administration in respect of Cases A and B

Case A

- As mentioned in the Audit report, the ARC has convened Board meetings to discuss the matter. A series of discussion with the fund manager ensued.

- The discussion led to, among other things, the ARC Secretariat issuing letter to Fund Manager A expressing concerns on the part of the ARC (Annex A); ARC Board agreeing to test the water on possible disengagement of Fund Manager A (Annex B) while sending Fund Manager A another letter expressing grave concern on its performance (Annex C).

- The ARC Board did not discern any criminal or fraudulent act but was concerned about the effectiveness of the fund manager.

- Action was taken to terminate the management agreement and the fund manager ceased to manage the ARF on behalf of ARC with effect from 3 May 2002. (Please see press statement at Annex D.)

Case B

- Regarding the disposal of Case B, we consider that the fund manager acted on the basis of its professional judgment of the market situation.

- Fund Manager B reported to the ARC Board the disposal on 30 April 2003. The ARC Board did not discern any criminal or fraudulent act arising from Case B.

- The ARC Secretariat also sought clarification from Fund Manager B about Company B reportedly attracted US$16 million from the U.S.[1]. Fund Manager B did explain to the ARC Secretariat on 29 October 2003 the

[1] Item (p) on page 27 of the Audit report refers.

situation (Annex E) and met with the Secretariat on 17 November 2003.

- The main explanation was that the US$16 million investment reported in a press article was not new fund injection into Company B. Rather, the fund was prepared for the perceived loss-making operation for the next 24-36 months of a new company, staffed by the founders of Company B, to work on new technologies that would pursue a totally different product and business strategy, targeting cable operators in the U.S. as customers. In short, the US$16 million investment should not be interpreted as the valuation of Company B.

- In any event, the ARC has been taking action in the past two years to vary the terms of the management agreement to provide better protection for the ARC with effect, among other things, that management fee is reduced; the ARC may withdraw all undrawn / uncommitted funds with prior notice; and the ARC may object to any proposed investment in its absolute discretion. (Please see the management agreement and supplemental agreements attached at Annex F.)

Other follow-up actions

- The ARC has initiated discussion with existing fund managers to examine how control over the disposal of ARF investments by fund manager may be improved. (Please see Annex G.) The ARC will take into account market practice in this regard as necessary and appropriate.

- One of the fund managers has agreed in principle that controls on disposal of ARF investments may be strengthened (Annex H). As of 19 May 2004, the necessary legal document is being drafted.

- The ARC would aim at concluding this issue with the fund managers as soon as practicable.

END

***Note by Clerk, PAC:* Annexes A to H not attached.**

(h) Compliance with co-investment provision of the relevant management agreement

- In terms of system and process, the management agreements provide that the fund managers may co-invest in any of the investments on their own account or on account of their other clients provided that such co-investment shall be made upon commercial terms which are comparable to those applicable to the investments.

- The management agreements also require that the fund managers shall not, among other things, invest the ARF in any investments already invested by any other funds managed by the fund managers concerned without the prior written consent and approval of the Council which shall not be unreasonably withheld.

- In the three earlier management agreements concluded in November 1998, the management agreements did not make co-investment as a requirement as such.

- However, in the case of the fourth fund manager engaged by the ARC in March 2000 (Fund Manager B in Case B below and as mentioned in the Audit report), the relevant management agreement did make co-investment as a requirement.

- Take Case B as an example. The relevant management agreement requires co-investment. The initial investment proposal of Case B shows that a fund (other than ARF) managed by the fund manager will be co-investing[1]. In its quarterly report for October - December 2000, the fund manager reports that the ARC has invested US$1 million into Company B and that another fund managed by the fund manager is investing an additional US$2.5 million into Company B on the same term.[2]

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1 Please refer to paragraph (c) of page 1 of the initial investment proposal dated 13 December 2000 submitted to the Public Accounts Committee ("PAC") on 7 May 2004. The shareholding of 166,667 shares with post-funding 1.57% shareholding is with respect to the ARC. The shareholding of 416,667 with post-funding 3.94% shareholding is co-investment by a fund (other than ARF) managed by the fund manager, the name of which has been blotted in the version sent to the PAC on 7 May 2004.

2 Page 4 of the relevant quarterly report refers.

- Similarly for the follow-on investment proposal in Case B. The follow-on investment proposal shows that a fund (other than ARF) managed by the fund manager will be co-investing US$1 million[3]. In its quarterly report for January-March 2002, the fund manager reported that "[a] total of US$4 million has been raised in this round of funding with ..., X Fund[4] investing US$1 million and Applied Research Fund investing US$1 million".[5] There is no prima facie doubt on the compliance of co-investment.

- However, if doubts arise, the ARC may act as it sees fit. For instance, it may decline the investment proposal. In cases where the fund manager has committed any material breach of any of the provisions of the management agreement or fail to perform and discharge any of its duties or obligations which are of a material nature, the ARC may terminate the management agreement.

END

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3 Please refer to the third paragraph of page 1 of the follow-on investment proposal dated 1 February 2002 submitted to the PAC on 7 May 2004. It states that "... is committing US$1 million. The investment committee of ... has already approved the investment." This investor is a fund (other than ARF) managed by the fund manager concerned, the name of which has been blotted in the version sent to the PAC on 7 May 2004.

4 "X Fund" is the fund (other than ARF) managed by the fund manager concerned.

5 Page 2 of the relevant quarterly report refers.

(i) Improving the rate of return for the ARF surplus fund

- As stated in paragraph 4.6 of the Audit report, the Innovation and Technology Commission (ITC) has stated that, for funds which exceed the necessary liquidity level, it is willing to consider the audit recommendation on measures to improve the rate of return for ARF surplus funds.

- We are considering the possibility of hiring professional investment firms to manage the surplus funds for ARC. However, while this is a possibility, initially, we are concerned that this may not only incur costs for the engagement of such firms but it may at the same time incur risks to the ARF. We have to analyse this option carefully before deciding if this option should be pursued.

- In considering what may be done to improve the rate of return for ARF surplus funds, the ARC will consider factors such as expected return, the risk tolerance level, the associated costs and the necessary liquidity. It will need to strike the best balance that may best fit the operations, nature and objective of the ARF. The ARC may consider diversifying the placing of its surplus funds in forms other than bank deposits such as bonds, certificate of deposits or Exchange Fund papers. This will require further analysis and consultation with the ARC. We hope to be able to come to a decision as soon as practicable.

END