

Ref: ARC/300/16

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7 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 4 May. We confirm that the four officials mentioned in your letter will attend the public hearing on 10 May (9:00am to 10:30 am).

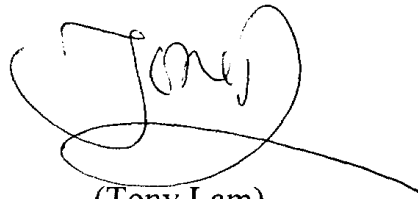
We also attach the requested information herewith for your reference, please :

- (a) A copy of the management agreements with fund managers is attached. Please note that names of individual companies or persons have been blotted. We have also highlighted information, such as fee levels, which may be particularly commercially sensitive. We should be grateful if you would treat the information with due care.

The Applied Research Council (ARC) engages private sector legal firms to provide legal services for it. The ARC has sought legal advice from them when drafting the management agreements.

- (b) The management agreements do not contain provisions allowing fund managers to receive commission for their sale of investee companies' shares from the buyers concerned.
- (c) The investments in question were considered and approved by the ARC through circulation of papers. There were no minutes as such.
- (d) The information which was furnished to the ARC by the fund managers in support of the initial and follow-on investments in Companies A and B are attached. Some of the specifics, such as individual names of companies and persons, in the investment proposals have been blotted in view of commercial sensitivity.

Yours sincerely,



(Tony Lam)

for Commissioner for Innovation and Technology

- cc Secretary for Commerce, Industry and Technology)
- Director of Audit) – w/encl.
- Secretary for Financial Services and The Treasury)
- (Attn : Mr Manfred Wong)

****Note by Clerk, PAC: The management agreements and the information mentioned in (d) above are not attached, except for the co-investment provisions in the agreements and the Initial Investment Proposal for Case A.***

**Extract from the Management Agreement
dated 27th March 2000
showing the provisions concerning co-investment**

7. Conflict of Interest

7.1 The Council acknowledges and agrees that the Manager and any member of the Group may act as investment manager or adviser to other persons in relation to other investment business or transactions. In particular, the Manager and any member of the Group may :-

X **X** **X** **X** **X**

(c) co-invest in any of the Investments whether on its own account or on account of its other clients provided that such co-investment shall be made upon commercial terms which are comparable to those applicable to the Investments.

X **X** **X** **X** **X**

7.3 The Manager shall not do any of the following without the prior written consent and approval of the Council which shall not be unreasonably withheld :-

X **X** **X** **X** **X**

(b) invest the Fund in any investments already invested by any other funds managed by the Manager; or

X **X** **X** **X** **X**

Schedule 1

Objective, Guidelines and Restrictions

X **X** **X** **X** **X**

2. Investment Guidelines and Restrictions

X **X** **X** **X** **X**

- (g) The aggregate total amount of all the Investments (including follow-on investments) on the last day of the sixth (6th) Year of the term of this Agreement must be less than or equal to fifty per cent. (50%) of the aggregate total amount of all other investments in the same relevant Investee Companies made by the Manager on the same day, whether on its own account or on behalf of any other person.

Case A :

Initial Investment Proposal

Vetting Report for Applied Research Fund

1. Company Information

Certificate No: BR21770989-000-06-99-1
Date of Incorporation: JUNE 25, 1998
Name of Business: [REDACTED] (" [REDACTED] ")
Registered office address: [REDACTED]
Business Address: [REDACTED]
Nature of Business: Online toy and pop-culture retail community
Status: Corporation
Estimated investment from ARC: HK\$16 Million

2. Shareholders & Directors

The following are the shareholders of [REDACTED] Limited:

[REDACTED]	20%
[REDACTED]	16%
[REDACTED]	15%
[REDACTED]	24.5%
[REDACTED]	24.5%

The directors of [REDACTED] are: [REDACTED]

3. Business Activities

[REDACTED] is currently the largest site retailing brand-name American and Japanese toys, action figures, collectors items, movies, anime and delivering related content through its proprietary [REDACTED] and affiliate sites.

[REDACTED] has recently expanded its reach into the greater niche of toy related products with the introduction of more mass market items such as videos, computer/video games,

[REDACTED]

[REDACTED]

comics, manga, sci-fi/fantasy books, game cheats and anime, as well as unique Hong Kong and Japanese movies and print.

[REDACTED] takes advantage of the fact that Hong Kong is the toy capital and hub of the world, and builds a state of the art e-commerce site around it. In fact, [REDACTED] is now the largest site of its kind in the world. Exports from Hong Kong and Japan (toys, computer/video games, movies, comics, actors) are some of the hottest properties in the US and Europe. The three top cartoons on TNT's Cartoon Network are Japanese exports (Pokemon, Dragonball, Sailormoon).

The Company is also an Internet leader in toy sales and content about Star Wars and its related topics. [REDACTED] is poised to take full advantage of the impact of the new Star Wars films premiering in May 1999 and running through to 2005, and the massive merchandising wave that will follow.

[REDACTED] has secured a unique niche in bringing these products to the market. Carrying the largest selection of toys, hosting some of the most popular related sites and producing the most unique and original content have garnered [REDACTED] a reputation as the first stop on the Net for this group.

Taking advantage of new strategic relationships with suppliers, [REDACTED] will increase its inventory count to over 8,000 items by July 1999 and to over 12,000 items by October 1. These relationships allow [REDACTED] to maintain much of its stock in virtual inventory, purchasing from suppliers only after an order has been confirmed, thereby stretching its purchasing power to its furthest extent.

With the addition of new auction sites, trading areas, chat rooms, clubs and the expanding affiliate network, [REDACTED] will create a large advertising platform to market to a wide range of advertisers targeting our community demographic.

To exploit the depth of products and content on site, [REDACTED] will work with six of the largest portals and communities on the Internet. These relationships will form the backbone of [REDACTED]'s sales, community and affiliations.

Since [REDACTED] is a pure e-commerce company, it does not suffer from the limitation in setting up physical retail shops. [REDACTED] takes advantage of the wide penetration of the Internet and with [REDACTED] [REDACTED] has effectively setup a global retail store that can be accessed by anyone in the world with an Internet connection.

Without the physical limitation, [REDACTED] is able to expand aggressively through business alliances. Working with the major community sites, (ie Lycos, Geocities, Xoom.com, FortuneCity.com) [REDACTED] will strive to develop the fastest growing and largest affiliate network on the Internet. Over 2.25 million new members per month will have the opportunity to affiliate with [REDACTED] to provide links, share content and even build their own virtual store from [REDACTED] merchandise.

[REDACTED]

The Company is also signing on with a number of networks (ie AOL, Lycos, Xoom.com) to provide original content and exclusive merchandise to their respective members.

Not only will [REDACTED] receive widespread marketing coverage, but actual sales and product endorsement from some of the most reputable groups online today.

4. Application of Technology

[REDACTED] is developing, integrating, and applying state of the art technologies in the fields of software integration, broadband-delivery entertainment, 3-D user interfaces, and customizable content interfaces to create a unique shopping, supply chain management and entertainment platform.

The Company is developing a showcase site inconjunction with Intershop, the leading e-commerce middle-ware provider. [REDACTED] will intergrate its shopping platform with all aspects of its operation.

[REDACTED] start by using Intershop Enterprise Edition 3.0, the leading electronic commerce middle-ware. Intershop's powerful eCommerce development platform has the core infrastructure and extensibility to meet the needs of our enterprise market. With its Template Language Extension (TLE) capability, extreme degree of customization and development is easily achievable which enable us to provide our customers the best shopping experience.

A high performance website requires a potent database, Sybase Adaptive Server Enterprise Edition XI was chosen as the back-end database engine. Being the only ISO9001 DBMS certified database in the market, high performance and availability is guaranteed. Sybase Adaptive Server also provides high performance for transactions processing and the capability to adapt to the unpredictable requirements of the Internet. It integrates seamlessly with Intershop for a total robust eCommerce backbone.

Other advanced technologies are used to streamline and expedite the order fulfillment process. Real-time, SET encrypted credit card data transaction is used for customers' protection against unauthorized access. A multi-carrier, enterprise-wide shipping system from Neopost called PS600 is integrated to Intershop to provide fast and accurate shipping to the customers. The PS600 is integrated together with our warehouse management & logistics systems for better resource planning.

To offer our affiliates the easiest to use interface and the fastest time-to-market, BeFree Version 3.0 was selected as our affiliates management program. BFAST (BeFree Affiliate Serving Technology) offers our merchants a full array of decision-support tools to maximize their online revenues and BFIT (BeFree Intelligent Targeting) allows our merchants to centrally place their advertisements according to their targeted audiences. It is a complete advertising solution that incorporate the placement, tracking, automated campaign fulfillment, reporting, and invoicing tailored for their needs. BeFree also features Virtual Shelf Space for sales of advertising for extra revenue generation.

[REDACTED]

Opensite Auction 4.0 Merchant Edition was chosen as our auction engine. Auto Bidding and Bidding Watch are just some of the advanced features of Opensite. Other features include automatic encryption, digital certificate compatibility, etc. Its easy to use interface makes our auction site fun and effective for our customers. And with its taut integration with the Intershop storefront, customization is never a problem.

[REDACTED] also used EShare Expressions 4.0 to form our online users community. As being the pre-eminent expert in human interaction on the Internet, not only it is able to provide conventional text based online chatting, but full multimedia support is also included in Expressions 4.0. Streaming or prerecorded video, audio, and live conversations are all possibilities of Expressions 4.0. These allow us to create a full featured, unparalleled, and effective community web sites.

WebTrends Professional Suite is used to constantly monitor our website. Its features includes; Log Analysis which provide detailed web site analysis and traffic reporting; Proxy Server analysis which keeps track of the usage trends and better understand the servers' efficiency; Link Analysis and Quality Control which is to improve the quality, performance, and integrity of our web site; and the most important Site Monitoring, Alerting and Recovery feature to minimize out site's downtime as much as possible.

One of the most exciting aspects of the [REDACTED] site is its strategic alliance with [REDACTED]. Together with Muse, [REDACTED] will create the first totally integrated 3-D, multi-person, e-commerce shopping experiences.

In order to integrate so many different external technologies, [REDACTED] has hired a team of over fifteen highly skilled developers. [REDACTED] development team has been able to tightly integrate different technologies into one easy to use product. By Q4 1999, [REDACTED] will have one of the most sophisticated sites on the Internet. A fully integrated retail, entertainment and supply chain system.

5. Hong Kong Operation

[REDACTED] now has more than twenty people in development, integration and buying of advertising content.

6. Key Personnel

PRESIDENT/CEO

[REDACTED], 33, holds a BA and MA in clinical psychology from [REDACTED]. He has an extensive background in developing start-up ventures. Mr. [REDACTED] has founded/co-founded a number of companies including [REDACTED] (an early leader in micro-breweries, IPO on NASDAQ in 1996), [REDACTED] (an Internet based research and analytic product for the real estate market), [REDACTED] (a Hong Kong based marketing and advertising company) as well as developing and arranging funding for many others such as [REDACTED] (develops and markets

[REDACTED]
[REDACTED]
high-tech computer peripherals including rapid prototyping systems) and [REDACTED]
[REDACTED] which produces international standard food products for the global market in
China and Hong Kong. His background in start-up companies and venture capital are
valuable assets to the Company.

DIRECTOR OF BUSINESS DEVELOPMENT

[REDACTED] 31, received his BA in International Relations from [REDACTED]
University. He has gained valuable experience working in various industries such as
freight forwarding, print/premium production, and media. Mr. [REDACTED]'s previous two
positions were Accounts Director for [REDACTED] a digital design studio and Business
Development Manager for [REDACTED]. Mr. [REDACTED] is one of the co-founders
of [REDACTED] and is responsible for business development and also chairs the product
committee.

WEB DIRECTOR

[REDACTED] 26, has been working in the multimedia and Internet industry for the past 5
years. Originally from Vancouver, Canada, Mr. [REDACTED] moved to Hong Kong after finishing
design school. Since then, he has been an integral part of production of interactive CD-
ROM and corporate web-sites for highly visible clients such as [REDACTED], [REDACTED],
[REDACTED] and [REDACTED]. Mr. [REDACTED], the other co-founder, is responsible for the
creation, development, and marketing of the web-site.

Editor-in-Chief

[REDACTED] 28, has worked in the collecting field for nearly ten years, having
written and edited for [REDACTED], [REDACTED], and the [REDACTED]
[REDACTED] recognized as the foundation publication for all comic book related
collecting. [REDACTED] holds an M.S. in Professional Journalism from [REDACTED] University and
an M.F.A. in Creative Writing and Marketing from [REDACTED] University. He
is an Associate Professor in the English department at [REDACTED] in New York. His work as
an editor with [REDACTED] earned him a place in the collecting community as an
authority on toys and comic pricing and collecting. He also served as founding editor of
[REDACTED], the well-received national news-stand publication that first incorporated
collecting and entertainment news into one package. Recognizing the potential of the
internet in relation to collecting, [REDACTED] began working for the on-line branch of the
[REDACTED] Company and their collecting division, notably in relation to their
auctionuniverse.com holding, where he served as contributing editor.

IT Manager

[REDACTED] 35, received his BS in Electronic Engineering/Computer Science from
[REDACTED] London. His first management position was as Senior
Programmer/Hardware Specialist for [REDACTED] in London prior to his emigrating
to Hong Kong where he took the position of Senior Specialist with [REDACTED] overseeing

[REDACTED]
[REDACTED]
financial services IT. [REDACTED]'s most recent position was Senior Manager IT for [REDACTED] in Hong Kong. [REDACTED] specialises in developing large scale networks and software integrtrion. He will be overseeing all development of the [REDACTED] site. [REDACTED] has been with [REDACTED] for 3 months.

7. Startup Status

Began Development in June '98, operational in September '98.

8. Conflict of Interest Declaration

[REDACTED] and [REDACTED] two funds managed by [REDACTED] have invested a total of US\$1,250,000 into [REDACTED] during different times in 1998. Mr. [REDACTED] Executive Director of [REDACTED] serves on the Board of Directors of [REDACTED] on behalf of the two funds. Mr. [REDACTED] has no direct personal interest in [REDACTED].

It is anticipated that a Conflict of Interest will occur as [REDACTED] seeks to invest the Applied Research Fund into [REDACTED] as agreed in Clause 7.3(b) of the Management Agreement between [REDACTED] and the Applied Research Council.

[REDACTED] hereby wishes to resolve this Conflict of Interest by co-investing into [REDACTED] under the terms and conditions set by the third party lead investors group consisting of [REDACTED] and [REDACTED] *dependent on*
[REDACTED] will not participate in the negotiations of the terms and conditions by [REDACTED] and [REDACTED] but will co-invest together with these parties under the terms and conditions set by the two parties.

[REDACTED] is investing in [REDACTED] with the intent of hosting the company as a showcase in the future [REDACTED] project.