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Panel on Commerce and Industry

Meeting on 16 January 2018

Updated background brief on the Innovation and Technology Venture Fund

Purpose

This paper provides updated background information on the Innovation and Technology Venture Fund ("ITVF"), and gives a summary of the views and concerns expressed by members on the issue during previous discussions.

Background

2. Inadequate private sector investment in technology is a major challenge for innovation and technology ("I&T") development in Hong Kong. In 2013, the gross expenditure on research and development ("GERD") in Hong Kong was HK\$15.6 billion, which translated to 0.73% as a ratio to Gross Domestic Product. The total expenditure on research and development ("R&D") in the private sector was HK\$7 billion or 45% of GERD, with the public sector taking up the remaining 55%. This contrasts significantly with the observed international norm of about 40:60 whereby the private sector makes the majority contribution to R&D expenditure.

3. The 2016 Policy Address announced that the Government would set aside HK\$2 billion to set up an ITVF for co-investing with private venture capital ("VC") funds on a matching basis so as to encourage investment from VC funds in local I&T start-ups. Subsequently, the 2016-2017 Budget delivered on 24 February 2016 announced the Government's proposal to launch the HK\$2 billion ITVF as one of the new measures to offer comprehensive support to start-ups.

Moreover, the Government would extend the Internship Programme¹ under the Innovation and Technology Fund² to cover the start-ups to be funded by ITVF, in a bid to encourage more university graduates to enter the field of I&T.

4. With the Finance Committee's ("FC") approval of the funding proposal of ITVF at its meeting on 12 July 2016, ITVF was launched in mid-September 2017. The Government and individual VC funds will invest in eligible local I&T start-ups concurrently at an overall ratio of approximately 1:2. Carried interests and other performance incentives will be provided as appropriate. ITVF is open for application by VC funds until 15 January 2018. The Administration expects to announce the selection result in April 2018.

Management framework of the Innovation and Technology Venture Fund

5. Through a special-purpose vehicle The Innovation and Technology Venture Fund Corporation ("ITVFC"), ITVF co-invests with VC funds selected as co-investment partners in I&T start-ups with adequate presence in Hong Kong (local I&T start-ups) at an overall matching investment ratio of approximately 1:2.

Venture capital funds as co-investment partners

6. A VC fund, whether it is incorporated in Hong Kong or overseas, and whether it is a newly established or an existing fund, is eligible to apply for selection as a co-investment partner as long as it meets the eligibility.³ The

¹ The Internship Programme supports organizations undertaking research and development ("R&D") projects funded by the Innovation and Technology Fund ("ITF") to recruit graduates from local universities as interns to assist in the R&D projects. Each project can engage up to two interns at any one time for a maximum period of 24 months. The internship allowance for graduates with a Bachelor degree and that for graduates with a Master or higher degree are HK\$16,000 and HK\$19,000 respectively.

² ITF is a statutory fund administered by the Innovation and Technology Commission to provide financial support to a spectrum of activities that boost Hong Kong's innovation and technology ("I&T") capacity, ranging from applied research and R&D, technology transfer and commercialization of related activities to promotional activities that foster an innovation culture within the community.

³ A venture capital fund is eligible to apply for selection as a co-investment partner as long as it meets the following eligibility:

- (a) having an investment focus in I&T start-ups;
- (b) having an investment coverage including Hong Kong;
- (c) having a minimum remaining committed capital of HK\$120 million as at the date of application; and
- (d) having a remaining fund life of at least five years to co-invest with the Innovation and Technology Venture Fund Corporation.

selection of VC funds will be based on a number of established criteria⁴ and the advice of an independent advisory committee. Upon selection as a co-investment partner, the VC fund concerned should have a place of business in Hong Kong to facilitate communication with local I&T start-ups and ITVFC. Also, the VC fund concerned must provide documents to prove its minimum remaining committed capital of HK\$120 million before entering into the Master Agreement with ITVFC.

Co-investment arrangement

7. The Master Agreement, which sets out the rights and obligations of both parties for co-investment, will be signed between the VC Fund concerned and ITVFC. Under the Master Agreement, the VC fund concerned has the obligation to invite ITVFC to co-invest in local I&T start-ups within a five-year window ("active investment period"). Throughout the active investment period, the VC fund concerned is responsible for identifying potential investee companies which qualify as eligible local I&T start-ups to ITVFC for co-investment.

Eligibility requirements of local innovation and technology start-ups

8. To be selected for co-investment, an eligible local I&T start-up must meet the following criteria:

- (a) it was incorporated under the Companies Ordinance (Cap. 622) within the last seven years with one of its offices (headquarters or regional office) or its main business operation or its key management or leadership team being located in Hong Kong;
- (b) it and its subsidiary(ies) (if any) have been engaging in I&T business, covering any part of the R&D or production chain in Hong Kong; and
- (c) it and its subsidiary(ies) (if any) have a total number of employees (including Hong Kong and overseas offices) being less than 250.

⁴ The criteria for the selection of co-investment partners include:

- (a) general background (e.g. the history and overall size of the fund and its financial capability and strength) (15%);
- (b) experience and performance of the fund (25%);
- (c) management team's experience (30%); and
- (d) local resources/knowledge for managing the co-investment fund (30%).

To be eligible for consideration, a co-investment partner must score at least half of the marks allotted to each individual criterion.

Previous discussions

9. Following the briefing by the Administration on the setting up of ITVF at the policy briefing-cum-meeting on 19 January 2016, the Panel on Commerce and Industry ("the Panel") was further briefed on the details of the proposed establishment of ITVF and its relevant proposed institutional arrangements and management framework at the meeting on 21 June 2016. At the FC meetings on 12 July 2016, FC members discussed and approved the funding proposal of ITVF. Subsequently, the Panel was updated on the launch of ITVF at the policy briefing-cum-meetings on 25 January and 17 October 2017 respectively.

Institutional arrangements and management framework

10. At the policy briefing-cum-meeting on 19 January 2016, some members enquired about the risk-sharing mechanism between the Government and the VC companies under ITVF.

11. The Administration responded that ITVF would co-invest in Hong Kong technology start-ups with a number of selected VC funds at an investment ratio of about 1:2 and such a risk-sharing mechanism was widely adopted by similar funds in other countries.

12. At the Panel meeting on 21 June 2016, some members enquired about the pros and cons of engaging VC funds under ITVF to manage the investment projects instead of having a direct oversight over these projects by the Government.

13. The Administration advised that under the proposed management framework of ITVF, the partner VC funds would be required to contribute a larger share of the investment in a start-up to ensure that they would exercise prudence. The Government would be a passive investor, making direct investment in the start-ups concurrently with the VC fund upon invitation of the latter on the same investment and exit terms as the VC fund, thereby ensuring that the interests of the Government and the partner VC funds in investment projects were aligned. In place of management fees, partner VC funds would be offered competitive carried interest plus the option to purchase the Government's shares within five years at a cost of the principal amount plus a suitable premium as the upside incentives. These were performance-based incentives contingent on the success of the start-up, thus providing an incentive for VCs to select start-ups with good potential and bringing added value to the investee companies to foster their business development.

14. Some members were keen to ensure that the Administration would exercise prudence over the use of public money. They enquired how the Administration

would select investee companies under ITVF at the Panel meeting on 21 June 2016.

15. The Administration replied that the Government would have the right of first refusal of co-investment in respect of any proposed investment by the VC fund. In deciding whether or not to accept the offer of VC funds on investment, the Administration would consider the business plan of the concerned start-up to see if its business would have any conflict with the existing or planned government policies or legislation. The Administration considered that the above practice was prudent for selection of investment projects.

16. At the same Panel meeting, some members noted that the Administration would decline an investment offer proposed by the VC fund if the businesses concerned were in conflict with Government policies (e.g. businesses that might be illegal in Hong Kong), and asked whether the Innovation and Technology Bureau would consult relevant government departments on the legality of the project proposed by the VC fund prior to making an investment decision under ITVF, or consider updating the local legislation to allow the application of the relevant technology/product in Hong Kong.

17. The Administration said that some products developed by Hong Kong companies were targeted at overseas markets. In determining whether to accept investment offers of VC funds, the Administration would take into consideration a number of factors, such as whether the concerned business and product were lawful in their targeted industries and markets.

Monitoring and review mechanism

18. At the policy briefing-cum-meeting on 16 January 2016, some members enquired whether the Administration would draw up key performance indicators ("KPIs") for ITVF to assess its effectiveness.

19. The Administration replied that the Advisory Committee on Innovation and Technology⁵ had been deliberating on the viable KPIs to assess policy effectiveness and would draw up relevant KPIs in due course.

20. At the Panel meeting on 21 June 2016, some members enquired whether the proposed special-purpose vehicle (i.e. ITVFC) and partner VC funds of ITVF would be subject to value-for-money audit of the Audit Commission. Some other

⁵ In March 2015, the Chief Executive announced the establishment of the Advisory Committee on Innovation and Technology ("the Advisory Committee"). The Advisory Committee advised the Government on the strategic and developmental enhancements of I&T in Hong Kong, with a focus on making the best use of Hong Kong's advantages of "one country" and "two systems", and further strengthening the connection and collaboration among the Government, industry, academia and research sectors.

members asked whether the financial statements of the investee companies would be made public.

21. The Administration responded that the proposed special-purpose vehicle would be subject to audit of the Audit Commission given that it was a limited company wholly-owned by the Government. The partner VC funds would sign a Master Agreement with the Government which set out the details of cooperation as well as the rights and obligations of each party. The partner VC funds would be required to submit annual financial statements to the Government, which would administer ITVF in accordance with the Master Agreement and prepare consolidated financial statements of ITVF. However, partner VC funds would not be subject to audit of the Audit Commission as they were commercial corporations. Moreover, the financial statements of the investee companies relating to the investment projects would be subject to thorough examination of the Administration.

22. At the FC meetings on 12 July 2016, some members asked how the Administration would monitor the operation of its partner VC funds and whether it would make public its investment results. Some members further requested the Administration to properly carry out performance management of ITVF.

23. The Administration explained that when selecting partner VC funds, it would evaluate their experience and investment track records. After the partner VC funds identified potential investee companies, the Administration would decide whether or not to agree with their selections and take part in them, thus forming a mechanism for multiple checks. Moreover, the Administration would disclose every year the projects in which it invested and the investment amounts. Furthermore, the Government had also invited the Corruption Prevention Department of the Independent Commission Against Corruption to advise on the mechanism of ITVF and the finalization of cooperation agreements in the future.

Latest position

24. The Administration will brief the Panel on the progress of the establishment of the HK\$2 billion ITVF.

Relevant papers

25. A list of relevant papers is shown in the **Appendix**.

List of relevant papers

Date of meeting	Meeting	Paper
19/1/2016	Panel on Commerce and Industry	<p>Administration's paper on "2016 Policy Address - Policy Initiatives of Commerce, Industry and Tourism Branch, Commerce and Economic Development Bureau" (LC Paper No. CB(1)436/15-16(03))</p> <p>Administration's paper on "2016 Policy Address - Policy Initiatives of Constitutional and Mainland Affairs Bureau in relation to Mainland and Taiwan co-operation" (LC Paper No. CB(1)436/15-16(04))</p> <p>Administration's paper on "2016 Policy Address - Policy Initiatives of Innovation and Technology Bureau" (LC Paper No. CB(1)436/15-16(05))</p> <p>Minutes of meeting (LC Paper No. CB(1)665/15-16)</p>
21/6/2016	Panel on Commerce and Industry	<p>Administration's paper on "Innovation and Technology Venture Fund" (LC Paper No. CB(1)1045/15-16(03))</p> <p>Background brief on the funding initiatives to support innovation and technology start-ups prepared by the Legislative Council Secretariat (LC Paper No. CB(1)1045/15-16(04))</p> <p>Minutes of meeting (LC Paper No. CB(1)1197/15-16)</p>
12/7/2016	Finance Committee	<p>Administration's paper on "Innovation and Technology Fund" (FCR(2016-17)67)</p> <p>Minutes of meetings (LC Paper No. FC333/15-16) (LC Paper No. FC334/15-16)</p>

Date of meeting	Meeting	Paper
25/1/2017	Panel on Commerce and Industry	<p>Administration's paper on "2017 Policy Address - Policy initiatives of Commerce, Industry and Tourism Branch, Commerce and Economic Development Bureau" (LC Paper No. CB(1)464/16-17(03))</p> <p>Administration's paper on "2017 Policy Address - Policy initiatives of Constitutional and Mainland Affairs Bureau in relation to Mainland co-operation and Taiwan affairs" (LC Paper No. CB(1)464/16-17(04))</p> <p>Administration's paper on "2017 Policy Address - Policy initiatives of Innovation and Technology Bureau" (LC Paper No. CB(1)464/16-17(05))</p> <p>Minutes of meeting (LC Paper No. CB(1)678/16-17)</p>
17/10/2017	Panel on Commerce and Industry	<p>Administration's paper on "2017 Policy Address - Policy initiatives of Commerce, Industry and Tourism Branch, Commerce and Economic Development Bureau Innovation and Technology Venture Fund" (LC Paper No. CB(1)20/17-18(01))</p> <p>Administration's paper on "2017 Policy Address - Policy initiatives of Constitutional and Mainland Affairs Bureau in relation to Mainland co-operation and Taiwan affairs" (LC Paper No. CB(1)20/17-18(02))</p> <p>Administration's paper on "2017 Policy Address - Policy initiatives of Innovation and Technology Bureau" (LC Paper No. CB(1)32/17-18(03))</p> <p>Minutes of meeting (LC Paper No. CB(1)341/17-18)</p>