



Schedule "1"

Ontario
Securities
Commission

Commission des
valeurs mobilières
de l'Ontario

P.O. Box 55, 19th Floor
20 Queen Street West
Toronto ON M5H 3S8

CP 55, 19^e étage
20, rue queen ouest
Toronto ON M5H 3S8

IN THE MATTER OF THE *SECURITIES ACT* R.S.O. 1990, C. S.5, AS AMENDED

-AND-

IN THE MATTER OF PETER GEORGE LEE

SETTLEMENT AGREEMENT

PART I – INTRODUCTION

1. By Notice of Hearing to be issued, the Ontario Securities Commission (the "Commission") will announce that it will hold a hearing to consider whether, pursuant to section 127 of the *Securities Act*, R.S.O. 1990, c. S-5, as amended (the "Act"), it is in the public interest for the Commission to make certain orders in respect of Peter George Lee ("Lee").

PART II – JOINT SETTLEMENT RECOMMENDATION

2. Staff of the Commission ("Staff") agree to recommend settlement of the proceeding against Lee in accordance with the terms and conditions set out below.

Lee consents to the making of an order against him in the form attached as Schedule "A" on the basis of the facts set out below.

PART III – AGREED FACTS

3. Lee agrees with the facts and conclusions set out in Parts III and IV herein.

A. BACKGROUND

i. Peter Lee

4. Lee holds Bachelor of Science and Bachelor of Commerce degrees.
5. In September 1982, he joined the Toronto office of a major national accounting firm and obtained his CA designation in 1985. In 1992, Lee became controller at a home decorating company. In 1997, Lee went to work as the Director of Financial Planning for a national department store.
6. Lee worked as a consultant for HIP Interactive Corporation ("HIP") to advise management and directors on potential acquisitions. In September or October of 2001, Lee joined the company full time as the company's CFO.
7. In May 2005 Lee left HIP and is now self-employed providing consulting services.

ii. HIP Interactive Corporation

8. HIP was incorporated in December 1999, operating principally out of Vancouver, Stratford, Mississauga and Montreal. It had expanded through a series of amalgamations of 15 to 16 companies.
9. HIP provided electronic entertainment products, distributed video and computer

games and movies. It also developed its own line of console accessories and video games.

10. HIP was formed into a number of divisions:
 - (a) The Video Games division generated about \$250 to 260 million in sales. It was responsible for the distribution of first party products such as consoles games and accessories;
 - (b) The PC Games division distributed software developed by other publishers and generated about \$45 to 50 million in sales;
 - (c) HIP started its own movie distribution business in March or April of 2002. The Movies division generated about \$60 million in sales and had its own accounting department and system;
 - (d) HIP Coin was a video arcade business. It provided equipment to places like the CN Tower where it placed arcade machines and shared the revenues with the locations. HIP Coin generated about \$3 million in gross revenues, and had its own accounting department;
 - (e) HIP Gear sold video games accessories. HIP Gear generated about \$20 million in sales during 2004/2005. Accounting for HIP Gear was carried out by the Video Games Division.
11. HIP had a corporate controller who managed, among other things, the corporate consolidation process and the corporate accounting. The controller drafted the quarterly financial statements and Management Discussion and Analysis ("MD&A") for management review and approval. HIP's year-end was March 31st.
12. On or about the fall of 2002, HIP implemented a new software program that the company used to manage its operational and reporting needs.

iii. Failure of HIP

13. On July 8, 2005, HIP announced that it was in default under the terms of its secured loan facility with Congress Financial Corporation (Canada) as a result of liquidity issues unrelated to the accounting irregularities described below.
14. On July 11, 2005, pursuant to an application by Congress Financial Corporation (Canada) under Section 47(1) of the *Bankruptcy and Insolvency Act*, the Ontario Superior Court of Justice appointed Ernst & Young LLP ("E&Y") the interim receivers for HIP following the failed discussions with a third party to provide interim relief in respect of HIP's immediate financing needs.

iv. Lee Self-Reporting - The Accounting Irregularities

15. In a letter dated October 3, 2005, Lee reported himself to the Professional Conduct Committee ("PCC") of the Institute of Chartered Accountants of Ontario ("ICAO"), pursuant to ICAO's Rules of Professional Conduct. In his reporting letter, he described his involvement in accounting irregularities at HIP.
16. Lee advised the PCC that he was aware, from at least July 2004, that the Video Games Division's inventory was overstated by \$1.3 million. This overstatement was caused by an accumulation of errors occurring during the period from the new software implementation date in the fall of 2002 to July 2004. The errors related to a malfunctioning of the new software program implemented at HIP in or about September 2002.
17. The new program had created inventory warehouse locations, referred to as VTR and VMR. In certain circumstances the system recorded inventory in either location, even though the inventory did not exist.
18. In his correspondence of October 3, 2005, Lee advised the PCC that, although he was aware of the inventory overstatement he took no steps to advise the CEO or the Board and instead instructed staff to hide the errors made.

19. By Order dated May 23, 2007, following charges issued February 21, 2007 against Lee, the ICAO Disciplinary Committee (“DC”) sanctioned Lee for his conduct as described herein. The DC ordered publicly that Lee be reprimanded, that he pay a fine of \$15,000 and costs of \$10,000, and that he be suspended from membership in ICAO for 12 months.

B. THE ACCOUNTING ERROR AND CONCEALMENT

i. The scheme to conceal the \$1.3 million inventory error

20. In July 2004, HIP's Director of Purchasing advised Lee that the inventory balance was overstated in the General Ledger (“G/L”) by approximately \$1.3 million. As stated in the above, the overstatement primarily related to inventory being recorded by the new software in HIP's perpetual inventory that didn't actually exist. While it is unclear who first coined the term, this inventory was referred to as "Virtual Inventory" by those, including Lee, who were aware of it.
21. Upon learning about the existence of the Virtual Inventory, Lee instructed HIP's IT specialist, who was most familiar with the new program, to investigate why the system was recording non-existent inventory.
22. The IT specialist identified three scenarios under which the system would record the Virtual Inventory in HIP's perpetual records. Those reasons related to the recording of price adjustments, quantity adjustments and customer short-shipments.
23. At no time did Lee advise HIP's CEO and President, the Board of Directors, the Audit Committee or the auditors of the \$1.3 million overstatement in inventory, despite receiving questions from the Board of Directors with respect to the increasing inventory balance during a Board meeting on August 10, 2004.
24. Lee did not instruct anyone to correct the G/L balance as at June 30, 2004.

Therefore, Lee was aware that the financial statements prepared for the first quarter, ended June 30, 2004, reflected the \$1.3 million overstatement in inventory.

25. During July 2004, an additional \$700,000 of Virtual Inventory had accumulated. The Virtual Inventory was now approaching \$2 million. At Lee's instructions, the additional \$700,000 of Virtual Inventory was written-off in July.
26. By September 30, 2004, the end of the second quarter, the G/L balance was still incorrect as a result of the continuing inventory overstatement of \$1.3 million. Lee was aware that the financial statements for the quarter-ended September 30, 2004 reflected the inventory overstatement.
27. Acting on Lee's instructions, the IT Specialist wrote off the accumulated \$1.3 million in Virtual Inventory in each of the months from October to December 2004.
29. Lee had decided that the best course of action was to eliminate the \$1.3 million inventory error in the biggest quarter (Q3) where no one would notice the correction. Lee believed that if they put through the adjustment for \$1.3 million in a lump sum it would be noticed and this would create a significant negative impact on the company. He therefore instructed staff to make the adjustment in the third quarter over 3 months.
30. In the course of conducting the audit of HIP's financial statements, HIP's auditors had set materiality for the relevant time at \$125,000.
31. By writing off the inventory in October, November and December Lee hoped to conceal the inventory overstatement over three quarters. In doing so he knew that the Q1 and Q2 financial statements of HIP, which had been released, were materially false.
32. Other than in receiving his regular remuneration from HIP, Lee did not profit

from his conduct described herein.

ii. The False Certificate of Interim Filings During Transition Period - Q1

33. Although Lee knew that inventory was overstated by \$1.3 million at the end of Q1 (June 30, 2004), he approved the first quarter financial statements and signed the Certificate of Interim Filings, dated August 2004 and filed with the Commission, wherein he certified that "...the interim filings do not contain any untrue statement of a material fact..." and that "...the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer...". Lee knew that these statements were untrue as a result of the \$1.3 million inventory error. Lee, therefore, made a statement in the Certificates of Interim Filing which he knew to be false and allowed the false interim financial statements to be filed with the Commission.

iii. The False Certificate of Interim Filings During Transition Period - Q2

34. Lee approved the second quarter financial statements (September 30, 2004) and signed the Certificate of Interim Filings, dated November 15, 2004 and filed with the Commission, wherein he again certified that "...the interim filings do not contain any untrue statement of a material fact..." and that "...the interim financial statements together with the other financial information included in the interim filings fairly present in all material respects the financial condition, results of operations and cash flows of the issuer...". Lee knew that these statements were untrue as a result of the \$1.3 million inventory error. Lee, therefore, made a statement in the Certificates of Interim Filing which he knew to be false and allowed the false interim financial statements to be filed with the Commission.

iv. The Management Representation Letter to the Auditors

35. For the quarter ended September 30, 2004 Lee signed the Management Representation letter to HIP's auditors. In this letter, Lee represented that the interim financial statements were fairly stated knowing that they were not because of the inventory overstatement.
36. Lee also made a series of representations which, given the issue with respect to the \$1.3 million inventory error, were untrue, including the representation that "...there are no significant and unusual transactions that have occurred..." and "...there are no significant deficiencies, including material weaknesses, in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize and report financial data."

v. Investigation

37. On April 11, 2005 members of the HIP Board raised questions about the nature of the adjustment to inventory that took place during the third quarter. In response Lee prepared a memo describing the reasons why Lee did not disclose the overstatement of inventory but instead embarked upon a scheme to conceal the error and write it down in Q3.
38. The auditors were engaged by the Board to investigate the nature and extent of the error. The auditors prepared a report of their findings, in which they stated that there was "a deliberate attempt to deceive management, auditors and securities regulators re: VTR by Peter Lee".
39. The auditors issued draft financial statements for the year ended March 31, 2005, which were presented to the Board in June 2005. However, the financial statements had not been finalized prior to the appointment of Ernst & Young LLP ("E&Y") as the interim receivers for HIP on July 11, 2005.

**PART IV – CONDUCT CONTRARY TO ONTARIO SECURITIES LAW
AND THE PUBLIC INTEREST**

40. By engaging in the conduct described above, Lee has breached Ontario securities law by contravening s. 122(1)(b) of the *Act* and has acted contrary to the public interest.

PART V – RESPONDENTS' POSITION

41. It is Lee's position that he believed that if the error with respect to inventory surfaced it would have a significant detrimental effect on the business of HIP.

PART VI – TERMS OF SETTLEMENT

42. Lee agrees to the terms of settlement listed below.
43. The Commission will make an order pursuant to s. 127(1) and s. 127.1:
- (a) Approving the settlement agreement;
 - (b) that Lee be reprimanded;
 - (c) that Lee resign all positions that he holds as a director or officer of a reporting issuer;
 - (d) that Lee be prohibited from becoming or acting as a director or officer of any reporting issuer for a period of 15 years commencing on the date of the Commission's order;
 - (e) that Lee be prohibited from becoming or acting as a director or officer of any registrant for a period of 15 years commencing on the date of the Commission's order;
 - (f) that Lee pay an administrative penalty of \$13,000; and
 - (g) that Lee pay the Commission's costs of the investigation and hearing in the amount of \$2,000.
44. Lee undertakes that he will consent to an Order made by any provincial or territorial securities regulatory authority in Canada containing any or all of the

prohibitions set out in paragraphs 43(d) and (e) above. These prohibitions may be modified to reflect the provisions of the relevant provincial or territorial securities law.

PART VII – STAFF COMMITMENT

45. If this agreement is approved by the Commission, Staff will not initiate any proceeding under Ontario securities law in relation to the facts set out in Part III of this agreement, subject to the provisions of paragraph 46 below.
46. If this settlement agreement is approved by the Commission and at any subsequent time Lee fails to honour the terms of the settlement set out in paragraphs 42, 43, 44, and 50, Staff reserve the right to bring proceedings under Ontario securities law against Lee based on, but not limited to, the facts set out in Part III of this settlement agreement, as well as the as the breach of the settlement agreement.

PART VIII – PROCEDURE FOR APPROVAL OF SETTLEMENT

47. Approval of this settlement will be sought at a public hearing before the Commission, in accordance with the procedures set out in this settlement agreement and the Commission's Rules of Practice.
48. Staff and Lee agree that this settlement agreement will constitute the entirety of the agreed facts to be submitted at the settlement hearing regarding Lee's conduct in this matter, unless the parties agree that further facts should be submitted at the Settlement Hearing.
49. If this settlement agreement is approved by the Commission, Lee agrees to waive his rights to a full hearing, judicial review, or appeal of this matter under the *Act*.
50. If this settlement agreement is approved by the Commission, neither party will make any public statement that is inconsistent with this settlement agreement.

51. Whether or not this settlement agreement is approved by the Commission, Lee agrees that he will not, in any proceeding, refer to or rely upon this agreement or the negotiation or process of approval of this agreement as the basis for any attack on the Commission's jurisdiction, alleged bias, alleged unfairness or any other remedies or challenges that may otherwise be available.

PART IX – DISCLOSURE OF AGREEMENT

52. If, for any reason whatsoever, this settlement agreement is not approved by the Commission, or an order in the form attached as Schedule "A" to this settlement agreement is not made by the Commission:
- i. this settlement agreement and its terms, including all discussions and negotiations between Staff and Lee leading up to their presentation at the Settlement Hearing, shall be without prejudice to Staff and Lee; and
 - ii. each of Staff and Lee will be entitled to all available proceedings, remedies and challenges, including proceeding to a hearing of the allegations to be contained in the Statement of Allegations, unaffected by this agreement or the settlement discussions/negotiations.
53. The terms of this settlement agreement will be treated as confidential by both parties until approved by the Commission. Any obligations of confidentiality will terminate upon approval of this settlement agreement by the Commission. The terms of this settlement agreement will be treated as confidential forever if this settlement agreement is not approved for any reason whatsoever by the Commission, except with the written consent of both Lee and Staff or as may be required by law.

PART X – EXECUTION OF SETTLEMENT AGREEMENT

54. This agreement may be signed in one or more counterparts which together will constitute a binding agreement.
55. A facsimile copy of any signature will be as effective as an original signature.

Dated this 2nd day of July, 2008.

STAFF OF THE ONTARIO SECURITIES COMMISSION

“Michael Watson”

Michael Watson
Director, Enforcement Branch

PETER GEORGE LEE

“P G Lee”

Peter George Lee

“Cynthia Amsterdam”

Witness



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P.O. Box 55, 19th Floor
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Schedule "A"

IN THE MATTER OF THE *SECURITIES ACT* R.S.O. 1990, C. S.5, AS AMENDED

AND IN THE MATTER OF PETER GEORGE LEE

O R D E R (Sections 127 and 127.1)

WHEREAS on July 2, 2008, the Commission issued a Notice of Hearing pursuant to sections 127 and 127.1 of the *Securities Act* (the "Act"), accompanied by Staff's Statement of Allegations, in relation to a hearing to consider whether it is in the public interest to approve the settlement of the proceeding entered into between Staff of the Commission and the Respondent Peter George Lee ("Lee");

AND WHEREAS the Respondent entered into a settlement agreement dated July 2, 2008 (the "Settlement Agreement") in which the Respondent agreed to a settlement of this proceeding, subject to the approval of the Commission;

AND WHEREAS, in addition to the terms of the order below, Lee has undertaken to consent to an Order made by any provincial or territorial securities regulatory authority in Canada containing either or both of the prohibitions set out in paragraphs 4 and 5 below, as modified to reflect the provisions of the relevant provincial or territorial securities law;

AND UPON reviewing the Settlement Agreement and upon hearing submissions from counsel for Staff and the Respondent;

AND WHEREAS the Commission is of the opinion that it is in the public interest to make this Order;

IT IS ORDERED THAT:

1. the Settlement Agreement dated July 2, 2008, attached to this Order as Schedule “1”, is hereby approved;
2. Lee is hereby reprimanded;
3. Lee shall resign all positions that he holds as a director or officer of a reporting issuer;
4. Lee is prohibited from becoming or acting as a director or officer of any reporting issuer for a period of 15 years commencing on the date of this order;
5. Lee is prohibited from becoming or acting as a director or officer of any registrant for a period of 15 years commencing on the date of this order;
6. Lee shall pay an administrative penalty of \$13,000 immediately; and
7. Lee shall pay the Commission’s costs of the investigation and hearing in the amount of \$2,000 immediately.

DATED at Toronto this 3rd day of July, 2008.
