February 26, 2014

The Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

Submitted via electronic mail to reitsconsultation@sfc.hk

**Re: Consultation Paper on Amendments to the Code on Real Estate Investment Trusts**

Dear Sir/Madam:

This letter is submitted in response to the request for public comment by the Securities and Futures Commission ("SFC") with respect to the Consultation Paper on Amendments to the Code on Real Estate Investment Trusts (the "Consultation Paper").

APREA is submitting these comments on behalf of the following member organizations of the **Real Estate Equity Securitization Alliance (REESA)**:

- Association for Real Estate Securitization in Japan (ARES)
- Asia Pacific Real Estate Association (APREA)
- British Property Federation (BPF)
- European Public Real Estate Association (EPRA)
- National Association of Real Estate Investment Trusts in the United States (NAREIT®)
- Property Council of Australia (PCA)

REESA is a global alliance of representative real estate organizations and seeks to promote equity investment in real estate on a securitized basis. Together, the members of REESA represent the vast majority of constituent companies in the FTSE EPRA/NAREIT Global Real Estate Index. REESA focuses on cross-border investment, international taxation, financial reporting standards initiatives, and education outreach to investors. REESA members represent major operating real estate companies (including REITs) – companies that acquire, develop, lease, manage and opportunistically sell investment property.[1]

[1] REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe. The purpose and activities of REESA are discussed further in Appendix I.

Members of the organizations identified above would be pleased to meet with SFC to discuss any questions regarding our comments on the Consultation Paper.

We thank SFC for the opportunity to provide input on the Consultation Paper. If you would like to discuss our comments, please contact Asia Pacific Real Estate Association.

**REESA comments and recommendations on Consultation Paper on Amendments to the Code on Real Estate Investment Trusts**

*General Comments*

REESA be lieves that the success of REITs around the world is largely attributable to the appropriate flexibility of their governing rules, which generally rely on market forces rather than government-issued regulations to determine various important matters such as whether to develop or purchase properties.

REESA believes that investors, in making their investment decisions, are the persons and institutions best positioned to decide the level of risk appropriate to their particular circumstances. As a result, we are supportive of any changes that would allow the markets and investors to freely choose the level of risk and protection they deem appropriate. REESA therefore believes that the highest possible level of flexibility in respect of property development investments, related activities and other Relevant Investments should be introduced for Hong Kong REITs.

REESA does not believe that any cap should apply to development that a REIT undertakes for its own long-term investments. We respectfully see little difference if a REIT buys or constructs a property as an investor. The important consideration is that it intends to hold the developed asset as a long term investment.

With respect to the other restrictions and related changes (including setting of a GAV Cap, calculation of Property Development Costs, requiring additional periodic updates, and other "additional safeguards"), as we say we support the maximum amount of discretion being granted to the REITs and to the investors who place money in the REITs. To the extent greater freedoms can be achieved than described in the Consultation Paper (such as no GAV Cap, or allowing each REIT to itself determine how to calculate Property Development Costs), we would be supportive of those.

To the extent SFC is willing to pursue the tax changes described in Section 4.2 of the Financial Services Development Council (FSDC) Research Paper *Developing Hong Kong as a Capital Formation Centre for Real Estate Trusts* with the necessary authorities, REESA stands ready to work on developing such proposal as well.

***Question 1: Do you consider that flexibility in respect of property development investments and related activities should be introduced for REITs?***

For the reasons given above REESA considers that flexibility in respect of property development investments and related activities should be introduced for REITs.

At the moment Hong Kong REITs cannot participate in property development activities, and this concept is defined very broadly such that they can't even develop their own aging assets. So, currently REITs can only acquire investment properties in the market and are forbidden from building their own assets. A capacity to invest early in the project cycle would create pricing advantages and would also give a REIT some input and control over the final product. The current inability to redevelop aging assets is also suboptimal for investors. Buildings have life cycles, and not being able to undertake significant upgrading works will compel a REIT to sell the asset, at a price which would not reflect the full potential of the asset.

These restrictions do not apply in the US, Australia, Singapore, Malaysia or the UK. REIT investors make their investment decisions taking into account the REIT's development risks and other merits, such as asset quality, management profile, growth potential, and capital structure.

***Question 2: Do you consider that the 10% GAV Cap is set as an appropriate threshold?***

REESA's position is that there should not be a cap, for the reasons set out above.

The 10% GAV Cap is generally in line with some other markets, in particular Singapore. However, not every jurisdiction imposes limits on development. In Australia and the US it is left to the market to decide. US REITs may develop property for their own account that, once developed, they hold for investment. In the US context, the relevant inquiry is whether the property is held as investment (for the long term) or as inventory as a dealer (for the short term). The UK also distinguishes between properties held for investment and trading purposes. This rule provides the flexibility for those REITs that have property development expertise to benefit their shareholders by undertaking development for their own account, thereby achieving cost efficiency and savings. This rule also helps spur development by REITs with particular development and redevelopment expertise.

REESA supports the 10% GAV Cap as a minimum but encourages consideration of greater flexibility for the reasons mentioned above.

***Question 3: Do you have any comments on how the Property Development Costs should be calculated?***

Under the proposal, GAV is used as the base to set the 10% threshold. GAV will mainly reflect investment properties which are carried at fair value, excluding the expected costs to complete the properties under development and un-completed units acquired. Under HKFRS, both completed investment properties and investment properties under development should be carried at fair value. The proposed definition of Property Development Costs in 7.2A focuses on the historical cost basis and also includes the "expected" costs to complete the properties under development. As such, GAV and Property Development Costs are derived from different bases and are not comparable.

REESA recommends a more comprehensive calculation of the sum of "properties under development" and "aggregate contract value" (Note (2) to 7.1 of the REIT Code) to take into account the fair value element of properties under development. This calculation and subsequent disclosure should include:

- Acquisition/land costs
- Development costs
- Capitalised interest
- Development margins
- Affiliated fees (we assume that the transactions with connected persons requirements contained in Section 8 of REIT Code would also need to be complied with). To this end, separate disclosure of any fees borne by the REIT manager and reimbursed by the REIT should be provided.
- Leasing updates
- Expected timeframe for project and stabilisation.
- Project/construction contract type (fixed price or yield).

In addition, the basis of calculation should be in line with the requirements of HKFRS (for example, interest capitalization).

***Question 4: Do you have any comments on the frequency of periodic updates that should be provided to unitholders on the status of property development investments and related activities?***

REESA agrees with the proposals contained in paragraph 25 of the Consultation Paper.

***Question 5: What additional safeguards do you consider appropriate to ensure there will not be any material change to overall risk profile of a REIT despite the flexibility to engage in a limited extent of property development investments and related activities?***

REESA considers the safeguards currently contained in the REIT Code and proposed in the Consultation Paper are sufficient.

***Question 6: Do you have any comments on the proposed scope of the Relevant Investments and the proposed Maximum Cap?***

REESA agrees with the principle of expanding investment alternatives as it will provide more options for REIT managers to be able to manage a REIT's cash position and improve returns. We agree with the comments in the Consultation Paper regarding the duties and responsibilities of the REIT manager and disclosure requirements.

***Question 7: What other safeguards do you consider appropriate to be put in place corresponding to the proposal to allow for the Relevant Investments?***

The key and relevant information to be published for each of the Relevant Investments is likely to be quite varied. Monthly reporting on the value and key information of Relevant Investments may be onerous and not applicable, in particular for investments which are not listed. REESA considers that periodic updates of the investment portfolio and key information (such as fair value of the investment portfolio by types of investments, not the full investment portfolio) in the interim and annual reports of the REIT should be sufficient disclosure to investors.

***Other Issues – Tax***

The Financial Services Development Council paper *Developing Hong Kong as a Capital Formation Centre for REITs* proposes giving Hong Kong REITs the same tax transparency treatment that applies in other jurisdictions. "Tax transparency" means that as long as a REIT satisfies the requirement to distribute most of its income to unit holders, it will not be subject to income tax at the trust level. Tax is payable by unit holders at their marginal rate.

This tax advantage is a fundamental characteristic for REITs as an investment product and a key factor that contributes to REITs' popularity among investors, particularly pension funds. It is also a key element to the value proposition of REITs – with their high levels of distribution, tax transparency and liquidity benefit, they are a proxy for investing directly in real estate, enabling investors of all descriptions and sizes to invest in quality income-earning real estate through the stock market. If the tax transparency component is not there, the value proposition for investors is substantially diluted.

In Singapore, a REIT is not subject to tax and nor are individual investors (subject to certain qualifications). Offshore institutional investors are subject to a 10% withholding tax. A similar rate applies in Malaysia. This makes REIT investment in those markets a very attractive proposition for foreign institutional investors, particularly those that pay tax in their home jurisdictions at a lower marginal rate (such as Australian superannuation funds) or are exempt from tax. It is a much more attractive proposition than currently applies in Hong Kong. That is, for many institutional investors withholding tax of 10% as the only levy is much more attractive than receiving a dividend after deduction of 16.5% profits tax. This is why Singapore and Australia are benchmarks and a reason why they are more favoured jurisdictions.

Hong Kong stands alone amongst mature REIT markets in not providing for tax transparency, and the results of the APREA-commissioned research report on the impact that REITs have had on Asian economies confirm that this is a major reason for the Hong Kong REIT market not having kept up and realised its potential.

**Appendix I**

**REESA – The Real Estate Equity Securitization Alliance**

REESA is made up of seven real estate organizations around the world grounded in one or more facets of securitized real estate equity. REESA's broad mission is to improve the opportunities for investment in securitized real estate equity around the globe. The REESA member organizations are:

- Association for Real Estate Securitization in Japan (ARES)
- Asia Pacific Real Estate Association (APREA)
- British Property Federation (BPF)
- European Public Real Estate Association (EPRA)
- National Association of Real Estate Investment Trusts in the United States (NAREIT®)
- Property Council of Australia (PCA)
- Real Property Association of Canada (REALpac)

REESA has responded positively to the challenges presented by the developments in the global economy and, in particular, the global real estate markets. The benefits of collaboration on a global scale are increasingly valuable on major industry issues such as the sustainability of the built environment, tax treaties, corporate governance and research.

The formation of REESA was, in part, a direct response to the challenge and opportunity presented by the harmonization of accounting and financial reporting standards around the world. Given the size and importance of the real estate industry, our view is that there are considerable benefits to be gained by both accounting standard setters and the industry in developing consensus views on accounting and financial reporting matters, as well as on the application of accounting standards.

Since its formation REESA members have exchanged views on a number of accounting and tax related projects and shared these views with regulators and standards setters. These projects include OECD developments on cross border real estate flows and international tax treaties.