NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

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REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

February 25, 2014

VIA E-MAIL: reitsconsultation@sfc.hk

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

RE: Consultation Paper on Amendments to the Code on Real Estate Investment Trusts (the Consultation Paper)

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) thanks you for this opportunity to submit comments on the proposal discussing the above-referenced Consultation Paper (the Proposal) issued by the Securities and Futures Commission (Commission). NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

EXECUTIVE SUMMARY

NAREIT is pleased that Hong Kong is proposing to allow Hong Kong REITs to: 1) undertake property development investments and related activities, subject to a maximum threshold of 10% of the Hong Kong REIT's gross asset value (10% GAV Cap), and, 2) invest in the following financial instruments (Relevant Investments): a) securities listed on the Stock Exchange of Hong Kong Limited or other internationally recognized stock exchanges; b) unlisted debt securities; c) government and other public securities; and, d) local or overseas property funds,[1] provided that: i) the value of a Hong Kong REIT's holding of the Relevant Investments issued by any single group of companies does not exceed 5% of the gross asset value of the Hong Kong REIT; ii) the Relevant Investments are sufficiently liquid, can be readily acquired/disposed of under normal market conditions and in the absence of trading restrictions, and have transparent pricing; and, iii) at least 75% of the gross asset value of a REIT is invested in real estate that generates recurrent rental income at all times.

[1] "Property fund" is not defined in the Proposal.

As further set forth below, NAREIT recommends that Hong Kong consider the following changes and/or clarifications with respect to the Proposal: 1) allow Hong Kong REITs the option to be internally, rather than externally, managed; 2) clarify that a REIT may undertake unlimited development for its own account for purposes of long-term real estate ownership, and, 3) clarify that investments in stock exchange-listed REITs (at least with respect to REITs listed in Hong Kong) be considered "real estate assets" that Hong Kong REITs could own without any limitation. NAREIT's responses to specific questions raised by the Proposal are answered as noted in the discussion below.

DISCUSSION

I. Background

The U.S. Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through companies modeled after mutual funds. REITs are corporations or business trusts that combine the capital of many investors to benefit from a diversified portfolio of income-producing real estate, such as apartments, hotels, health care facilities, shopping centers, ski resorts, offices, timberlands, storage facilities, and warehouses. U.S. tax law requires REITs to distribute at least 90% of their taxable income to their shareholders. In exchange for distributing taxable income and any net capital gains (and for satisfying a number of other requirements to ensure that REITs remain real estate-focused), federal tax law grants REITs (and mutual funds) a dividends paid deduction (DPD). In 2012, publicly traded REITs distributed more than $29 billion to their shareholders.

The U.S. Congress' vision has been realized: as of February 20, 2014, 203 publicly traded REITs had a total market capitalization of almost $745 billion. Investors, large and small, have benefited from owning REITs: the 15-year compound annual return for the period ending December 31, 2013 of the S&P 500 stock index was 4.68%, while that of equity (property-owning, as opposed to mortgage-owning) REITs was 10.49%. The economy benefits from REITs as well – because REITs cannot pass through losses to investors (unlike partnerships), their focus must be on creating value for shareholders. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public equity REITs are around 35%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Including Hong Kong, over 25 countries have some form of REIT legislation in place that allows for a single level of taxation. We note this information because we believe that the U.S. REIT experience can be helpful in terms of the Commission's decisions with respect to Hong Kong REITs.

II. Authorize the Option of Internal Management

Before addressing some of the specific issues raised by the Proposal, we would like to raise the possibility that the Commission consider changes that would allow (but not mandate) internal management. Many investors believe that a REIT that is internally managed may address any potential conflict of interest issues arising from external management structures. Accordingly, NAREIT recommends that Hong Kong allow REITs the choice of being internally managed so

that they could be subject to the same rules as stock exchange-listed companies that focus on businesses other than real estate.

As originally created by the U.S. Congress in 1960, a U.S. REIT was only allowed to hold properties and its employees were not empowered to provide even basic real estate services to its tenants. The original statute required a REIT to engage the services of an "independent contractor" to provide such basic real estate services as maintenance of the properties the REIT owned. The practice developed in the United States that the independent contractor a REIT retained to provide these services was owned and controlled by the REIT's officers. This arrangement led to situations under which the REIT paid substantial sums to entities benefiting the REIT's officers, not the REIT shareholders.

It was not until the Tax Reform Act of 1986 that the U.S. Congress decided that REITs should be able to provide "customary services" to their tenants, thereby resolving potential conflicts of interest and allowing REIT management to maximize the revenue potential of REIT properties for the benefit of their investors. The 1986 change has been widely acknowledged as having been a necessary ingredient for the dramatic growth of publicly traded U.S. REITs beginning in the early 1990s. As with other publicly traded companies, employees of internally managed REITs do not work for other entities and therefore are fully focused on creating value for the shareholders. Today, U.S. REITs can be either internally or externally managed, but because of market preferences, about 94% of publicly traded equity U.S. REITs (as measured by equity market capitalization) are internally managed.

Therefore, we encourage the Commission to explore the possibility of allowing Hong Kong REITs the option to be to be internally managed. We note that the trend in Australian Listed Property Trusts to be "stapled" with corporations in effect has allowed the investors in those companies to reap the benefits of internal management.

III. Permit Development for REIT's Own Account

> Question 1: Do you consider that flexibility in respect of property development investments and related activities should be introduced for REITs?
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> Question 2: Do you consider that the 10% GAV Cap is set as an appropriate threshold?
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> 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?

NAREIT believes that flexibility in respect of property development investments and related activities should be introduced for Hong Kong REITs. Specifically, NAREIT recommends that Hong Kong REITs be permitted to develop for their own accounts ***without any limitation*** so long as the property is not held primarily for sale in the ordinary course of the REIT's business, and that a safe harbor be provided for rental property held for at least two years.

Thus, NAREIT believes that the 10% GAV Cap is too low, and that the experience of U.S. REITs may be instructive. In particular, U.S. REITs may develop property for their own account that, once developed, they hold for investment. In the U.S. 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). 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. After all, constructing a building for investment is merely another way for an landlord to acquire new assets. Our understanding is that similar rules apply with respect to Australian REITs – there is no limit on development provided that they hold the developed property for the production of rental income. This rule also helps spur development by U.S. REITs with particular development and redevelopment expertise.

With that said, U.S. tax law contains limitations that impede U.S. REITs from developing property primarily for sale (as opposed primarily to hold for the production of rental income). Hong Kong could implement a similar rule to limit any material change to the overall risk profile of a Hong Kong REIT. Specifically, under U.S. law gains attributable to the sale of "dealer property" are taxed to a U.S. REIT at a 100% rate. Thus, the REIT faces strong discouragement, but not loss of REIT status, from directly developing property for third parties. The determination of whether property is "dealer property" is based on the facts and circumstances of the situation, but a safe harbor does apply. A U.S. REIT may develop properties for third parties through its fully taxable subsidiary, the value of the securities of which may not be greater than 25% of the U.S. REIT's gross assets.

Specifically, no tax is imposed on a U.S. REIT's property sales if, among other requirements, the REIT has 1) held the property for at least 2 years, 2) not spent more than 30% of the net selling price of the property over the last 2 years, 3) not made more than 7 sales of property within the taxable year or the aggregate fair market value or adjusted bases of property sold during the taxable year does not exceed 10% of the fair market value or aggregate adjusted tax bases of all of the REIT's assets as of the beginning of the taxable year. Further, these objective tests are only a "safe harbor," and a REIT is not assessed the 100% tax if it can demonstrate that it did not act as a dealer based on the surrounding facts and circumstances.

IV. Permit Greater Flexibility in Respect of Investments

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

NAREIT supports the Commission's Proposal to allow greater flexibility in respect of Relevant Instruments. Doing so allows Hong Kong REITs the ability to earn investment income and asset appreciation while they are waiting for suitable real estate investments to materialize. With that said, NAREIT recommends that the Commission consider treating investments in exchange-listed REITs (at least with respect to REITs listed in Hong Kong) as "real estate assets" for purposes of the Hong Kong REIT rules so that Hong Kong REITs can own such investments without limitation.

As you may know, quarterly, at least 75% of a U.S. REIT's assets must consist of "real estate assets," Government securities, cash and cash items. The term "real estate assets" is defined broadly to include interests in real property (fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon), as well as interests in mortgages on real property, shares of other REITs, and any property that is attributable to the temporary investment of new capital. REITs may invest in U.S. properties or non-U.S. properties. U.S. tax law "looks through" all of the tiers of a REIT's ownership of fiscally transparent entities (like partnerships) to determine the real estate assets owned by the REIT. On the other hand, REITs cannot own more than 10% of the securities of any corporate entity other than another REIT, a taxable REIT subsidiary, or a "qualified REIT subsidiary" (a wholly owned subsidiary which is completely disregarded for U.S. tax purposes, and the income and assets of which are viewed as owned by the REIT).

The broad definition of "real estate assets" allows for a great amount of flexibility, not just for the newly formed REIT as it looks for investment opportunities, but also for the existing REIT as it considers other types of real estate related investment opportunities. Flexibility has been important to U.S. REITs because it has allowed them to own new types of properties as market conditions change. For example, in 1994, office REITs comprised only 4% of the total U.S. REIT market while in 2004, office REITs comprised about 12% of the total U.S. REIT market. As of December 31, 2013, office REITs comprised over 15% of the total REIT market. Similarly, retail REITs were 35% of the total REIT market in 1994, and, as of December 31, 2013, they were over 23% of the total REIT market.

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