26th February, 2014

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

CONSULTATION PAPER ON AMENDMENTS TO THE CODE ON REAL ESTATE INVESTMENT TRUSTS

Introduction

The Asia Pacific Real Estate Association (APREA) is delighted to have the opportunity to provide its comments on the Securities and Futures Commission's important *Consultation Paper on Amendments to the Code on Real Estate Investment Trusts.* APREA is the representative voice for REITs and publicly traded real estate companies with an interest in Asian real estate and capital markets. APREA's members are REITs and other businesses that own, operate and finance income-producing real estate, global institutional investors, professional service firms, financial institutions and academic institutions.

APREA applauds the Securities and Futures Commission for the initiatives contained in the Consultation Paper.

Since the launch of the first REIT in Asia (Japan, September 2001) the REIT market has grown enormously. Market capitalisation is around US$146 billion and rising. With more investment grade real estate continually being developed, and with the prospect of new REIT markets in India, the Philippines and elsewhere, it is quite conceivable that this could exceed US$500 billion in the near future. The success of this product has been driven by the success of the REIT markets in Japan and Singapore, which together account for around 78% of Asian REIT market capitalisation.

The market capitalisation of Singapore's REIT market is approaching US$50 billion, and given the fixed REIT investment mandates that many global institutional investors have, it is strongly arguable that much of this capital would not be in the Singapore economy but for its successful REIT market.

Recent APREA research (*The Impact That REITs Have Had on Asian Economies)* also highlights a number of broader benefits that REITs brought to economies in Asia.

According to recent research commissioned by APREA, China currently accounts for 7% of the global investable real estate market, with this share forecast to increase to almost 30% of the global market by

2031. With no REIT legislation yet in place in China, the likelihood of more and more listings of Chinese property in offshore REITs should be obvious.

Hong Kong should stand to benefit most from this, and thereby attracting significant additional capital into the economy. However, currently the "go to" jurisdiction for cross-border listings is Singapore. Hong Kong has missed a significant amount of this business and the market has not grown anywhere like Japan and Singapore.

APREA believes that the measures proposed in the Consultation Paper will be beneficial and effective in increasing the attractiveness of the Hong Kong REIT regime.

This submission reflects the views and contributions of a significant cross-section of APREA members – institutional investors, REIT managers and financial institutions.

General comments

APREA believes 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.

APREA 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. APREA 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.

With respect to the other restrictions and related changes (including setting of a GAV Cap, calculation of Property Development Costs, requiring of additional periodic updates, and other "additional safeguards"), 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 a higher GAV Cap or 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 the 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, APREA stands ready to work on developing such proposal as well.

Proposal for introducing flexibility in respect of investments in properties under development or engagement in property development activities

We respond to the questions as follows:

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 APREA 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 and Malaysia.

In Singapore the capacity to engage in development activities has given REIT managers additional capital management flexibility and flow-on benefits to investors which are currently not available in Hong Kong. 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.

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

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). 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.

APREA supports the 10% GAV Cap but also encourages consideration of greater flexibility for the reasons mentioned above.

We also note that for smaller REITs a 10% cap will be too small to be meaningful. If the 10% GAV Cap is preferred, then to make it more meaningful for the REITs the SFC should consider a qualification, namely, once an asset has been held for a qualifying period it can be re-developed without being taken into account in the GAV Cap, and it must be held for a post-re-development qualifying period.

We also believe that clarification is needed with regard to the relationship of note (2) to 7.8 – it does not seem clear if a property developed by a REIT can be sold earlier if approved by special resolution, or is the 2 year minimum holding period absolute? Given this is a note to 7.8, it would appear that a property subject to the 2 year minimum holding can be sold earlier if approved by special resolution. However, this needs to be clarified in the drafting.

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.

APREA 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).

There should also be provision of an adequate buffer, which is usually included in development costs as a contingency cost under current industry practice. This margin will be an estimate only, leading up to completion, but the project costs should contain an allowance for time and cost overruns.

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

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

APREA agrees with the proposals contained in paragraph 25 of the Consultation Paper. In addition, the REIT manager should be required to disclose as soon as practicable any material change to project estimates previously provided (with respect to each of costs, timing and revenue). We do not believe that this is necessarily covered in the general provisions of 10.3 of the REIT Code.

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?**

If the property is sold within the minimum holding period, the cost base for the portion sold should be disclosed.

APREA does not believe any other additional safeguards are necessary. However, we have some additional observations and suggestions for clarification.

A development project may take the form of mixed use development, and there may be an opportunity for a REIT to participate in a share of the project. However, clarification is required as to whether 7.7A of the REIT Code applies (requiring majority ownership and control). This may be relevant where the REIT's mandate has been limited to particular sectors. However, selling down part shares in developments may not be possible due to other reasons (e.g. titles and division of land rights). Consideration should be given to allowing the REIT to divest a partial interest in a development project into a fund structure allowing it to receive some consideration in lieu of pure development returns (that is, in the form of a passive/preferred return). Consideration should also be given to allowing a REIT to participate in a development project as a minority investor on the condition that the REIT manager will have the right to manage all or part of the mixed used property.

Depending upon how "Property Development Cost" is determined (see our comments in pages 3 and 4 above) it may be possible for the Property Development cost to be materially understated such that the GAV Cap is exceeded. In these circumstances a period of grace for rectification should apply (see our comments in page 7 below).

With regard to the proposed additional Note (2) to 7.8 of the REIT Code we suggest , for clarification, that in the case of investments in properties under the scheme's property development activities pursuant to 7.2A, the scheme shall hold such properties within the scheme for a period of at least two years from the completion of the development*, unless the scheme has clearly communicated to unitholders the rationale for disposal and the unitholders have given their consent to such sale by way of a special resolution*. The current drafting of the proposed additional Note (2) to paragraph 7.8 does not seem to allow the possibility of an earlier disposal, even with unitholder approval.

Proposal for introducing flexibility in respect of investments in financial instruments

We respond to the questions as follows:

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

APREA 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 returns to investors.

However, in enabling REITs to invest in financial instruments it needs to be ensured that exposure to Relevant Investments would not significantly adversely impact on the risk characteristics of a REIT. The proposed limit of 25% caps the risk exposure of the REIT and is in line with other regimes. However, we agree with paragraph 39 of the Consultation Paper, so that while each individual investment may not be large the total allocation should be considered in assessing the overall risk.

With regard to certain of the proposed Relevant Investments:

- Listed securities in different sectors and markets may have quite different risk characteristics to property and REITs, so not all types of securities may be suitable. In addition, if an investment is made in a listed property developer this may indirectly increase a REIT's development exposure. Also, would an investment in a listed developer constitute part of the proposed 10% GAV Cap with respect to development? If it is to be included in the GAV Cap calculation, there may be practical issues with respect to disclosure in assessing the exact value of development exposure.

- Different types of unlisted debt, government and public securities will offer different layers and tranches of risk and hence not all of these investments may be appropriate.

- Local or overseas property funds investment will allow a REIT to gain exposure to property on a part share basis. It needs to be clear that such investment would not be affected by 7A of the REIT Code (requiring majority ownership and control).

- Unlisted property funds contain varying levels of gearing and as a result the risk of the exposure may vary. Hence, the underlying property fund exposure may be different when reported on a grossed up basis (for both assets and debts). Furthermore, clarification may be required as to whether any look through exposures in unlisted property fund investments would be relevant to 7.9 of the REIT Code (limitations on borrowing). Inclusion of debt exposure in unlisted property fund investments may present issues and difficulties in calculating the amount of gearing in the fund attributable to the REIT.

- Unlisted property funds may also undertake development or take the form of a development fund, thereby increasing a REIT's development exposure. Clarification may be required as to whether a look through on this form of development exposure would fall within the proposed 10% GAV Cap for development. There may be practical issues, with respect to disclosure and calculation of development exposure, in assessing the exact value of development in unlisted property fund investments.

The proposed restriction of a REIT's holding of Relevant Investments issued by any single group to 5% of the GAV of the REIT may inhibit opportunities for takeovers unless the acquiring REIT is much larger relative to the target. The interrelationship of this proposal and takeovers provisions needs to be considered, to ensure that it will not adversely impact on M&A activity. Clarification is needed on how these proposals are intended to interact with the Takeovers Code.

More generally, while APREA supports the general principles and goals of greater disclosure and transparency, in some circumstances detailed disclosure of key information may not be desirable or possible (for example, M&A activity and terms of confidentiality agreements). Detailed disclosure of key information on all investments in the portfolio may not be possible due to terms of confidentiality of the relevant investment (in particular, unlisted property funds).

Clarification is needed on the concept of "sufficiently liquid". Unlisted property funds are typically not liquid in the sense that listed securities are. In some instances liquidity may not be readily available (for example, local and overseas property funds may have limited liquidity and/or redemption options; for unlisted debt securities liquidity may not be readily available). The criteria may make it difficult to invest in these Relevant Investments.

Paragraph 35 (footnote 16) states that machinery, plant and equipment installed in a property are "real estate related assets" and fall within the definition of Relevant Investments. However, these assets are classified as part of the "Investment Property" under accounting standards and it would therefore be inconsistent for them to be classified as "Relevant Investments". Similarly, with regard to footnote 17, hedging instruments which are simple hedges relating to interest rates and/or currency on a REIT's investments or borrowing should be excluded from the classification of Relevant Investments.

Finally, if a REIT engages with a developer to undertake the development, there may be an opportunity for the REIT to finance the developer hence generating a yield during the development period (often referred to as a fund-through arrangement in Australia). Consideration should be

given to expanding the list of financial instruments to include fund through funding arrangements where the developed property is owned by the REIT.

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. APREA 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. Under the current requirements of the Hong Kong Companies Ordinance (Tenth Schedule paragraph 9) companies are required to disclose listed and unlisted equity and debt securities in Hong Kong or overseas.

   Also, consideration should be given to materiality tests within the disclosure requirements.

   With the ability to hold indirect holdings, consideration should also be given to:

   - proper REIT manager fee calculation on non-direct real estate holdings, and

   - Fees within the sub-vehicles and disclosure of the fees. Investments in unlisted property funds will attract fees (e.g. base fees, promotes). While fees and returns can readily be assessed with respect to properties held directly by a REIT, these may be more difficult to assess if held as a stake in a sub-vehicle, for example, due to constraints contained in confidentiality agreements.

General

The Consultation Paper (paragraph 45) states that a REIT will be required to make an announcement in the event of a breach of the GAV Cap or the Maximum Cap, and disclose measures taken to rectify the breach and the proposed rectification period. It will also be required to set out in its annual and interim report the progress of rectification.

Whilst it is the REIT manager's responsibility to monitor for and if necessary disclose any breach of the Maximum Cap, a REIT should not be penalised if the breach due to an increase in cash (from disposals or an equity fund raising) or a fall in property value due to a material adverse change in market conditions.

Furthermore, a grace period for rectification should be permitted. In Singapore, where as a result of disposal or capital raising the proportion of real estate investments falls to a level between 50% and 75% of GAV, it has a 12 months period of grace to return to the Maximum Cap level, and longer if the percentage goes below 50%.

APREA also suggests that there should not be any requirement to divest any assets that breach the Maximum Cap if the cause of the breach is any of the following:

- the appreciation or depreciation of the value of the REIT's assets;
- any distributions made from the REIT; or
- In respect of investments in listed securities, any changes in the total issued nominal amount of securities arising from rights, bonuses or other benefits that are capital in nature.

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 in 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 not realising its potential.

Trust Deed Amendments

We understand that if the proposed amendments to the REIT Code take effect it will be necessary for a REIT to amend its trust deed (by unitholder special resolution) before it can engage in any of the broader classes of investment. This is because, as we understand it, trust deeds are required to restate the permissible investment provisions of the REIT Code.

We respectfully submit that this imposes an unnecessary burden on REITs and will be time consuming and costly for managers and investors alike. The current and proposed provisions of the REIT Code contain ample protection for investors without this additional layer being proposed.

This situation does not exist in either Australia or Singapore – constituent documents are not required to be so prescriptive. The same situation did exist at one time in Singapore but now trust deeds incorporate code provisions by reference. This creates greater flexibility and avoids the need to seek unitholder approval to adopt in the deed what is permitted by law.

If trust deeds do need to be amended by special resolution to give effect to the changes in the REIT Code, we ask the Commission to consider permitting additional amendments to create a more flexible approach to incorporation of future changes in the REIT Code, in line with Singapore.

The following paragraphs summarise the positions in Australia and Singapore.

In Australia the constitutions of registered managed investment schemes need to set out the powers of the manager to make investments and deal in scheme property but these can be (and usually are) framed broadly.

Generally, the constitutions of listed REITs in Australia are kept flexible and say little about investment strategy. However, the capital raising disclosure documents describe the investment strategy and the REIT is expected to comply with that strategy.

There are various legal issues to consider relating to statements in the disclosure document if the manager wishes to vary from that strategy, so the disclosure document also tends to be expressed in a way that gives some flexibility. For example, the disclosure document for a new fund set up to hold a portfolio of assets in a particular class (e.g. office or retail) is likely to say that the manager may acquire additional assets of that class in the future if in the manager's opinion they satisfy the fund's objectives, that the manager has the ability to sell any asset in the portfolio if the manager decides it is appropriate to do so, and that the manager has the ability to undertake development opportunities where it considers it appropriate to do so.

Another legal constraint is that the REIT is subject to the usual listing rule requirement to notify the ASX of any proposed significant change to the nature or scale of its activities and to obtain security holder approval if the ASX requires.

In Singapore trust deeds are sufficiently flexible to allow the REIT to make any investments permitted by the Code on Collective Investment Schemes prevailing at the relevant time. Such automatic alignment to changes in the code is allowed by the Monetary Authority of Singapore.

A Singapore REIT's deed therefore need not be so prescriptive on the REIT's investment strategies and policies. However, if listed on SGX, its prospectus will have to disclose a summary of its restrictions (on investments and diversification) and that its investment policy will be adhered to for at least three years (unless approved by a special resolution of unitholders). After the period, whether or not unitholder approval will be required for any change in strategy will be dependent upon the terms of the trust deed.

Typically, S-REIT trust deeds have a broad general description on their investments. The lead in usually states that the trust is constituted to invest in real estate, real estate related assets and/or such other permissible investments as may be prescribed under the CIS Code.

In addition, there is typically an additional clause relating to restrictions in investments, stating that no investment shall be made by the trust which would result in non-compliance with the relevant laws, regulations and guidelines and that the trust may only invest in authorised investments as prescribed from time to time in the CIS Code.