



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

A CONSULTATION PAPER ON THE DRAFT CODE ON REAL ESTATE INVESTMENT TRUSTS

Hong Kong
March 2003

**CONSULTATION PAPER ON
THE DRAFT CODE ON
REAL ESTATE INVESTMENT TRUSTS (REITs)**

The Securities and Futures Commission invites market participants and interested parties to submit written comments on the proposals discussed in this consultation paper or to comment on related matters that might have a significant impact upon the proposals **no later than 9 April 2003**. Any person wishing to comment on the proposals should provide details of any organization whose views they represent.

Please note that the names of the commentators and the contents of their submissions may be published on the SFC website and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement attached to this consultation paper.

You may not wish your name and/or submission to be published by the SFC. If this is the case, please state that you wish your name and/or submission to be withheld from publication when you make your submission.

Written comments may be sent

By mail to: Investment Products Department
The Securities and Futures Commission
12/F Edinburgh Tower
The Landmark
15 Queen's Road Central
Hong Kong

By fax to: (852) 2877 0318

By on-line submission: <http://www.hksfc.org.hk>

By e-mail to: reits@hksfc.org.hk

For further information, please contact the Investment Products Department at (852) 2840 9259.

Additional copies of the consultation paper may be obtained from the above address of the SFC. A copy of this paper can also be found on the SFC website at <http://www.hksfc.org.hk>.

Investment Products Department
Securities and Futures Commission
Hong Kong

7 March 2003

Personal Information Collection Statement

1. This Personal Information Collection Statement (“PICS”) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data¹ will be used following collection, what you are agreeing to with respect to the SFC’s use of your Personal Data and your rights under the PDPO.

Purpose of Collection

2. The Personal Data provided in your submission to the SFC in response to the Consultation Paper on the Draft Code on Real Estate Investment Trusts (“the Consultation Paper”) may be used by the SFC for one or more of the following purposes:
 - to administer the relevant Ordinances, rules, regulations, codes and guidelines made or promulgated pursuant to the powers vested in the SFC
 - for the purpose of performing the SFC’s statutory functions under the relevant Ordinances
 - for research and statistical purposes
 - other purposes permitted by law

Transfer of Personal Data

3. Personal Data may be disclosed by the SFC to the members of the public in Hong Kong and elsewhere, as part of the public consultation on the Consultation Paper. The names of persons who submit comments on the Consultation Paper together with the whole or part of their submission may be disclosed to members of the public. This will be done by publishing this information on the SFC website and in documents to be published by the SFC throughout and at the conclusion of the consultation period.

Access to Data

4. You have the right to request access to and correction of your Personal Data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data provided in your submission on the Consultation Paper. The SFC has the right to charge a reasonable fee for processing any data access request.

Enquiries

5. Any enquiries regarding the Personal Data provided in your submission on the Consultation Paper, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to:

¹ Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance, Cap 486 (“PDPO”).

The Data Privacy Officer
The Securities and Futures Commission
12/F, Edinburgh Tower
The Landmark
15 Queen' s Road Central
Hong Kong

A copy of the Privacy Policy Statement adopted by the SFC is available upon request.

CONSULTATION PAPER ON THE DRAFT CODE ON REAL ESTATE INVESTMENT TRUSTS (REITs)

INTRODUCTION

The Securities and Futures Commission invites comments from the public on the proposed Code on Real Estate Investment Trusts (the “Code”) which sets out the guidelines for authorising and regulating REITs in Hong Kong.

The aim of this consultation paper is to solicit market feedback on the proposed guidelines. These guidelines will set the standards and rules for the authorisation and regulation of REITs that are offered to the investing public in Hong Kong. A summary conclusion will be published after the end of the consultation period and all comments from the public will be carefully considered before the guidelines are finalized.

BACKGROUND

A REIT is a company or trust that is involved in the business of owning and managing property. In recent years, REITs have risen in importance in several major securities markets.

Since the beginning of last year, industry practitioners have requested the Commission to consider the feasibility of introducing REITs in Hong Kong. In response, staff have conducted in-depth research on the regulatory experiences regarding REITs in a number of major financial markets, namely, the United States, Australia, Japan, Korea and Singapore.

Chapter 7.14 of the Code on Unit Trusts and Mutual Funds clearly states that authorised funds are prohibited from investing in any type of real estate (including buildings) or interests in real estate. However, in view of the development of real estate investment trusts overseas, the Commission believes that this is a good time to consider the possibility of introducing REITs to Hong Kong to allow investors access to a broader range of investment products.

The Commission believes that given the unique features and investment characteristics of REITs, the most efficient and sensible way to introduce REITs in Hong Kong is to introduce a separate code to regulate REIT offerings. This code is designed to have a clearly defined, self-contained format and to provide both operational clarity and the flexibility for future expansion as the market evolves. The proposed Code is therefore the basic building block which lays the foundation for the future development of REITs in Hong Kong. The Commission will review and update the Code on a regular basis. The Commission foresees that there will be a learning period as the Commission and the market work together to develop this new investment product.

This consultation paper explains the investment nature and operational aspects of REITs, and provides a brief overview of REIT development in various overseas jurisdictions. The paper also attempts to summarise the key factors that are likely to contribute to REIT development, and the possible impact that REITs may have on Hong Kong's financial markets. The full version of the proposed Code for the regulation and authorisation of REITs is set out for public comment and consideration in Annex I of this consultation paper. The list of questions on which the Commission seeks public comment is summarised for quick reference in Annex II.

REGULATORY PRINCIPLES

In considering this new product and the relevant guidelines, one of our primary objectives is to ensure that sufficient investor safeguards are put in place. The Commission believes these safeguards should include: -

- proper management experience and expertise;
- clear description of the scheme's investment policy and objective(s);
- segregation of management and the safekeeping of assets;
- appropriate valuation methodology;
- adequate financial reporting;
- transparent and convenient exit mechanism;
- accurate, meaningful and timely disclosure of financial reports and scheme activities; and
- proper voting rights for investors on key issues relating to the interests of the REIT.

In drafting the proposed Code, the Commission has taken into consideration the regulatory experience of REITs in overseas markets. The feedback and comments gathered from this public consultation are vital for the purpose of finalising the Code. The Commission will seek to ensure a good balance between supporting market development and product innovation on the one hand, and upholding investor protection on the other.

DISCUSSION

What is REIT?

Typically, a REIT acquires, operates and manages income-generating real estate, such as shopping centres, hotels and offices, and residential property like apartment buildings. Some REITs also finance real estate projects. A typical REIT has the following characteristics:

- has a *clear investment strategy* focused on owning and managing properties;
- has a legal *obligation to pay out most of its taxable income to shareholders* in the form of dividends in order to enjoy some form of tax exemption;

- is not subject to corporate tax as long as it complies with the minimum payout ratio requirement above;
- is subject to public oversight and required to ensure transparency of operations by distributing reports to investors;
- is required to comply with certain investment restrictions, such as borrowing limits and prohibitions from property development activities or use of certain financial instruments; and
- can be privately held or listed on a stock exchange.

In some countries such as Australia, Netherlands and Belgium, REITs are also known as “Listed Property Trusts” (LPTs).

Types of REITs

Most REITs are identified by their property type, such as commercial, industrial or residential, or by geographical focus such as US, Japan, Singapore, etc. There are typically three broad types of REITs, namely, equity REITs, mortgage REITs and hybrid REITs. REITs are generally classified according to the investment strategies they employ:

- *Equity REITs*
This type of REITs primarily own and operate real estate, and derive their revenue principally from the renting of such properties.
- *Mortgage REITs*
Mortgage REITs focus on providing loans to real estate owners and operators. As such, their main source of revenue comes from interest earned on their mortgage portfolios.
- *Hybrid REITs*
This classification refers to an investment strategy that combines those of an equity REIT and a mortgage REIT. As such, this type of REITs may invest in a range of assets, including physical properties, mortgages or other types of related financial instruments.

How does a REIT operate

A REIT can be established either as a trust or a company. The followings are some important structural and regulatory aspects that all REITs need to consider very carefully.

Regulatory requirements

In most of the major jurisdictions, specific investment guidelines are imposed on REITs that are marketed to the public. These investment restrictions usually include: -

- asset allocation criteria such as a minimum percentage of assets that must be invested in real estate or related assets;
- prohibition from investment in vacant land or property development projects;

- a maximum borrowing limit; and
- a minimum dividend payout ratio.

These requirements are designed to provide investors with a clear understanding of the investment policy and strategy of REITs, and help ensure that such schemes are not over leveraged.

Management of REITs

In the US, REITs are usually operating companies that are *internally managed* by a board of directors who make policies on investments and borrowings, and actively manage the properties with a view to maximising rental income. Such an arrangement helps to ensure that the properties are managed in the best interest of REIT investors. As companies, US REITs are subject to a well-established body of law concerning contract and corporate law matters regarding real estate ownership. There is also an established framework for corporate governance.

In Australia, REITs are generally *externally managed* by institutional managers who provide fund management and real estate services. However, to ensure that the external managers act in the best interest of the investors, investor protection mechanisms are built into the trust deeds to allow investors to vote out the managers for poor performance, and require unit-holders' approval for related party transactions. Further, management fees are usually set by reference to the total asset values of the REITs to ensure that the management acts in the best interest of unit-holders.

Listing of REITs

REIT shares/units are often listed and traded on major stock exchanges. Investors are able to purchase shares/units of REITs through an exchange and are not subject to restrictions as to the minimum amount of shares/units that can be purchased. REIT investors are kept informed of the listed REIT's operations and financial status mainly through its regular filings with the stock exchange. These filings include financial reports, notices and key fund information.

Where a REIT is not listed, a regular redemption and subscription facility is created for investors to provide liquidity and exit.

Valuation of REITs

The method of valuing a REIT differs from that of a traditional collective investment scheme in two material aspects. From an operational point of view, a REIT is required to value its underlying assets on a regular basis using one or a combination of the following methods:

- By discounting future cash income from its operations using the prevailing interest rate, i.e. measuring the "net present value" of the REIT's income stream (method used mainly in Australia);
- By discounting the funds from operations, inclusive of depreciation charges (method used mainly in the US); or

- Estimating the net asset value with reference to recent transactions of properties with similar characteristics and features (most often used in Asia).

If a REIT is listed, it will be priced in the market everyday in relation to its net asset value. The premium or discount to the net asset value (NAV) of a REIT is influenced by both tangible factors (such as assessed NAV) and intangible factors. Important intangible factors include the quality of corporate governance, expected growth of dividends, expected capital returns, and expected growth from future investment strategy.

Disclosure and Reporting Requirements

In addition to disclosing its investment policy, financial information and risk factors, a REIT must also disclose in its offering document such information pertaining to its underlying properties, including the location of the properties, financial arrangements, the policy with respect to property investments, principal terms of the leases, occupancy rates and any proposed programs for the renovation, improvement or refurbishment of such properties. A listed REIT has to comply on an on-going basis with the filing and disclosure requirements under the relevant listing regime (such as the filing of financial reports and the disclosure of related party transactions).

OVERVIEW OF REITs IN OVERSEAS JURISDICTIONS

Today, there are at least eight REIT / LPT markets in the world. The concept of a REIT originated in the US in 1960 and the US is currently the world's largest REIT market. Subsequently, Australia introduced the REIT concept in the 1970s. European markets were exposed to REITs when the Netherlands introduced REITs to its market in 1980s. The growth of REITs gathered momentum in the 1990s as Canada and Belgium launched REITs in 1993 and 1995 respectively. In 2000, Japan was the first country to introduce this product in Asia. In 2001, both Korea and Singapore followed suit by enacting their own REIT legislation.

A snapshot of the development of REITs in the US, Australia, Japan, Singapore and Korea is provided in Annex III to this consultation document.

FACTORS CONTRIBUTING TO REIT DEVELOPMENT

REITs are successful in mature markets such as the US and Australia possibly due to the fact that products and regulatory frameworks in these jurisdictions have had a longer history in adjusting to and fulfilling the needs of the market. After reviewing the regulatory experience in these jurisdictions, we have summarised some important factors that have helped the development and growth of REITs.

Key factors that may contribute to the success of REITs:-

(1) A focused investment strategy

REITs offer investors certainty with regard to property investment activities. Like other collective investment schemes, a REIT has a well-defined, focused and transparent investment strategy. Due to regulatory requirements, a REIT is unlikely to deviate from or diversify into non-property investment business. This stability in investment strategy contributes towards more certain and predictable management and business behaviour.

(2) Scalable investment in a diversified portfolio

Most small investors are attracted to REITs as these products provide them with the opportunity to invest in balanced, diversified and large-scale property portfolios without having to commit very substantial amounts of capital. Investors are therefore able to participate in property investments within the limits of their financial means.

(3) Accessibility and tradability

The ability for investors to trade REIT shares/units on major stock exchanges has made REITS much more accessible to the average investor. In the US, REITs are traded as stocks on the exchange, and investors usually pay minimal commission to trade. In general, investors are able to conveniently access key corporate information on the exchange's web-site. This accessibility brings about higher transparency of disclosure and better information flow that are essential for building greater investor confidence over time.

From an asset management point of view, the listing of a REIT is likely to enhance its trading liquidity. From a strategic point of view, a listed status will help REITs raise new capital either for strategic expansion or acquisition of assets as such needs arise. From the investors' point of view, the listing of REITs provides them with a quick exit option.

(4) Tax transparency

REITs in both the US and Australia have transparent tax arrangements. Tax transparency in the US, for instance, means that the dividend distribution from the REITs will not be taxed at the REIT level. Only the dividends received will be subject to tax at the individual level.

Investors in REITs can benefit by taking advantage of higher after-tax returns. This taxation benefit has been an important factor to the success of REITs in the US and Australia.

In Hong Kong, this tax transparency advantage is not as potent a benefit as Hong Kong investors are subject to a relatively low taxation regime. At the individual investor level, there are no capital gains tax or dividend income tax. At the scheme

level, all authorised funds are exempt from profits tax. However, in view of the nature of the investment, REITs will be subject to property tax (please refer to the section on “REITs and Tax Related Issues”). Given the simple taxation regime in Hong Kong, the tax arrangement in Hong Kong is generally regarded as transparent and competitive.

(5) Transparency of REITs

Any investment fund that does not provide sufficient disclosure to investors runs the risk of investors losing confidence in its operational integrity, mainly due to the lack of information.

Proper disclosure on key operational aspects of a REIT helps investors gain an understanding as to how the scheme works and the possible investment risks involved. Such information is instrumental to the purpose of enabling investors to make informed investment decisions. In most cases, relevant information about REITs include:

- management strategy;
- portfolio holdings;
- tenancy agreements;
- rental yields; and
- financial arrangements.

REITs that are listed on the stock exchange will be subject to public and regulatory oversight and analysts’ scrutiny. Such oversight and scrutiny will help to encourage better corporate management behaviour and corporate governance.

(6) Attractive yields and low correlation to equity market

With their high payout ratios and attractive yields, REITs are considered by many investors a viable alternative to fixed income instruments. An investor may rely on a REIT to provide a stable cash flow, and a means to reduce investment volatility in the property and equity market. REITs generally thrive during periods of falling interest rates, as these products provide dividend yields¹ that are comparable to fixed income instruments. Statistically, REITs have been proven to provide an effective means of portfolio diversification due to their low correlation with stock price movement².

¹ By 2002-end, REITs in the US provide an average dividend yield of 7.3%, which represents a 350 basis-points above the yield on 10-year US Treasury bonds. In Australia, average dividend yield for LPTs is approximately 7.6%, which is 250 basis-points above the 10-year treasury bond.

² According to NAREIT, the comparative total return investment correlation between equity REITs and the S&P 500 for the period between January 1992 and December 2002 stayed relatively low at 0.26.

POTENTIAL IMPACT OF REITs ON THE HONG KONG FINANCIAL MARKET

This section broadly examines, from a regulator's standpoint, how REITs may impact our financial markets. The observations below are not meant to be exhaustive, but are designed to facilitate further discussion on the key issues involved.

REITs and the banking sector

REITs may provide an alternative means of financing to the property sector. Traditionally, banks in Hong Kong have been important providers of capital to the property market. In recent years, property related loans have become an increasingly significant part of banks' lending portfolios³.

During a property market downturn, the asset quality of property portfolios may deteriorate, leading to a rise in business risk to banks. REITs, as an alternative source of capital, may help reduce the systemic risks arising from over-reliance on bank lending for property investment.

REIT and the Hong Kong property market

In our view, REITs may have three broad implications on the Hong Kong property market. REITs are likely to:

- enlarge the potential pool of property investors;
- increase liquidity in the secondary property market;
- help reduce the inherent volatility of the property market cycle by creating a more stable and long term investment demand from institutional investors; and
- deepen the property market.

Depending on the attractiveness of the assets and yields, REITs may attract investment from both retail and institutional investors. If so, the increase in property investors will have an impact on both the demand and liquidity of the property market. However, the extent of the impact is largely dependent on the actual fund size of the REITs and the prevailing economic conditions in the market at the time.

It should be noted that movement in property prices is, to a certain degree, a reflection of the overall economy as well as the demand and supply situation in the property market. While REITs are unlikely to reverse trends in property prices or eliminate the inherent cyclical nature of the property market, REITs may, as long-term buy-and-hold investors, act as a stabilising factor in the property market.

³ According to statistics from the Hong Kong Monetary Authority (HKMA), as of September 2002 direct property exposure accounted for 58% of the total loans and advances for use in Hong Kong made by authorized financial institutions. This compares to 40% in 1997.

REITs and Hong Kong property companies

REITs offer property companies a means to “monetise” otherwise illiquid real estate assets. By injecting their property assets into REITs, property companies can convert otherwise illiquid assets into cash. The improved liquidity could provide the property companies with more flexibility in re-deploying capital and strengthening capital management capability.

The choice of whether to inject properties into REITs depends on the cash requirements of the property companies and their long term investment and commercial objectives. However, it should be noted that the existence of REITs may pose potential competition to listed property companies that engage in similar property investment strategies for both investors’ capital and properties.

REITs and the Hong Kong Stock Market

As at the end of 2002, there were an estimated 99 property or property related companies listed on the Hong Kong stock exchange, with a total capitalisation of over HK\$423 billion and an average daily turnover of over HK\$915 million in the year 2002⁴. The property sector also accounted for 20% of reported earnings in the Hang Seng Index.

REITs may have three broad implications on the Hong Kong stock market. First, as a listed security, REITs may help increase trading volume of the stock market. Second, as an alternative property investment vehicle, REITs may draw investors’ capital away from those listed property companies with less transparent operations. Lastly, REITs may affect the share prices of listed companies that choose to transfer their property portfolios into a REIT structure. Such impact would, of course depend on the prices at which properties are transferred.

As at year end of 2002, REITs in the US accounted for 1.52% of the market capitalisation of the New York Stock Exchange, and 1.43% of its annual trading value. The Commission believes that, over time, REITs will develop a market presence in Hong Kong, as investors begin to appreciate their operational focus, stability in investment strategy, commitment to a specified payout ratio, and high level of transparency.

REITs and the Investment Management Industry

REITs may take the form of an externally or internally managed entity. In the case where a REIT is externally managed, the fund management company generally has the flexibility to delegate its functions, but not responsibility, to an external company that specialises in property management and operations. As such, the Commission expects to see a segregation of functions between the fund management company and the property management company.

We hope that the introduction of REITs to the Hong Kong market would create an environment that facilitates cooperation and partnership between fund managers and

⁴ Source: Stock Exchange of Hong Kong Monthly Trading Statistics

property managers. Such cooperation would help enhance the skills and sophistication of fund managers in managing alternative investment products, broaden the range of investment products that they can offer to the public, and at the same time bring about a synergy between the fund management and property management sectors.

REITs and Tax Related Issues

Under existing tax rules in Hong Kong⁵, unit trusts and mutual funds that are authorized by the Commission are exempt from profits tax. Nonetheless, as REITs will receive rental income from the properties that they own for income generation purposes, such rental income will be subject to property tax⁶.

In summary, it is understood that under the existing provisions in the IRO (Inland Revenue Ordinance), authorization of REITs in Hong Kong should have a broadly neutral impact on government tax revenue. Given the relatively low tax rates and the absence of capital gains or dividend income taxes in Hong Kong, the existing tax regime in Hong Kong is generally considered to be sufficiently competitive and conducive to the development of REITs in this market. With regard to stamp duty, it should be noted that this charge is an inherent cost of property investment, whether by way of a REIT or through an investor's direct purchase of a piece of property⁷.

REITs and the Investing Public

REITs were first created with the objective of enabling smaller investors to invest in large-scale income-generating real estate in a cost effective manner, with a relatively transparent and well defined investment strategy. Due to its regulated pay-out ratio, REITs are often considered as an attractive income generating investment and a possible alternative to bonds. Unlike equities, REITs are less susceptible to stock market volatility. According to statistics, REITs have a lower correlation with the stock market⁸ compared to typical equities. Hence, REITs can be considered as a means for portfolio diversification.

⁵ According to s.26A(1A) of the Inland Revenue Ordinance, any sums received or accrued in respect of a specified investment scheme by or to the following persons are not subject to profits tax:

- (i) an authorized mutual fund corporation or the trustee of an authorized unit trust;
- (ii) a mutual fund corporation or the trustee of a unit trust established outside Hong Kong where the Commissioner is satisfied that the mutual fund corporation or the unit trust (as the case may be) is a bona fide widely held investment scheme which complies with the requirements of a supervisory authority within an acceptable regulatory regime; or
- (iii) a person chargeable to tax under this Part in respect of any other similar collective investment scheme where the Commissioner is satisfied that the collective investment scheme is a bona fide widely held investment scheme which complies with the requirements of a supervisory authority within an acceptable regulatory regime.

⁶ According to s.5 of the Inland Revenue Ordinance, property tax shall be charged for each assessment year on every person being the owner of any land or buildings or land and buildings wherever situated in Hong Kong and shall be computed at the standard rate on the net assessable value of such land or buildings or land and buildings for each year.

⁷ As provided in Schedule 1 of the Stamp Duty Ordinance, stamp duty is chargeable at a rate of 3.75% (maximum applicable rate) of the value of the consideration where the latter exceeds HK\$6,720,000.

⁸ According to NAREIT, the comparative total return investment correlation between equity REITs and S&P 500 for the period between January 1992 and December 2002 stayed relatively low at 0.26.

REITs also offer retail investors the chance to participate, by committing a relatively small investment amount, in property holding and investment managed by professional real estate managers. As such, more retail investors may invest in property assets over a longer term.

MAJOR PROPOSALS IN THE DRAFT CODE ON REAL ESTATE INVESTMENT TRUSTS

Given the unique investment nature and operational aspects of REITs, it is considered appropriate to draft a separate Code for the authorisation and regulation of REITs, called the Code on REITs. It should be noted that the proposed Code outlines the core requirements and basic framework for the authorisation of REITs. It is expected that as REITs gain acceptance among the Hong Kong investing public, the Code can be expanded or modified at a later stage in response to market development.

The following paragraphs highlight the major proposals in the draft Code.

(1) Legal Structure of REITs

The Commission proposes that all REITs shall be structured in the form of a trust, to ensure clear segregation of assets of the REITs. In this regard, every REIT shall appoint a trustee that is functionally independent of the management company of the REIT, and that acts in the best interest of the unitholders.

(2) Responsibility and eligibility of Management Company of REITs

Since REITs are a new type of investment product in Hong Kong, local fund managers may not have expertise in managing REITs. However, given that there are two aspects to the management of REITs, namely fund management and property management, we propose that while the management company is to be responsible for the overall management of a REIT, it can delegate the property management function to a professionally qualified property manager. In doing so, the management company must carry out proper due diligence in the selection and on-going monitoring of its delegate.

The management company shall:

- (a) be licensed by the Commission to manage collective investment schemes;
- (b) have at least five years' track record in managing public funds; and
- (c) have at least two key personnel, each with at least five years of experience in analysing the property market in Hong Kong or advising on property investment in Hong Kong, including two years of experience with respect to the type of properties proposed by the scheme.

The management company shall ensure that its delegate is a company with good and established reputation in performing property management duties and has sufficient resources to carry out such duties. Such delegate shall have key personnel who are professionally qualified to manage properties, including at least five years of

experience in managing properties, of which two years must have been spent in the management of properties of the type and portfolios of the size similar to those proposed for the REIT.

The Commission will also consider REIT managers in such overseas jurisdictions that are considered acceptable to the Commission in order to help develop REIT management expertise among the investment managers in Hong Kong.

- Q1. Do you think that the eligibility requirements for the management company of REITs are sufficient? If not, why not and what other practical issues do you think we need to consider?*
- Q2. Do you think that the qualification requirements for the key personnel in the property management company of a REIT are sufficient? If not, why not?*
- Q3. To what extent do you think the management company shall delegate its property management function to a third party? Do you foresee any ambiguity arising from such segregation of duties? If so, how should this lack of clarity be dealt with?*
- Q4. What are your concerns if the management company manages a number of REITs which have similar investment objectives? How do you think such concerns should be addressed and why?*
- Q5. What are your concerns if the management company is related to the major shareholder of the REIT it manages? How do you think such concerns should be addressed and why?*

(3) Responsibility and eligibility of Trustee

The trustee of a REIT is required to fulfil the duties imposed on it under general trust law. The trustee is expected to exercise all reasonable care to ensure that the rights and interests of the unit holders are well protected, the assets are properly managed and held for the benefit of the holders of a REIT, and the properties are independently valued. In this regard, the Commission proposes that the trustee shall:

- be a licensed bank, subsidiary of a bank, or an overseas banking corporation that is acceptable to the Commission;
- possess at least three years of experience in providing safe-custody services to REITs or other schemes that operate in a manner similar to that required under this Code; and
- ensure adequate insurance coverage is arranged for the properties of a REIT.

- Q6. Do you think that the eligibility requirements for the trustee of a REIT are sufficient? If not, why not and what are the other practical issues that we need to consider?*

Q7. *Do you think the Code should stipulate minimum requirements for the insurance policies of the properties held by a REIT? Do you think the trustee should be responsible for ensuring compliance with insurance coverage? If not, who should take responsibility?*

(4) Responsibility and eligibility of Valuers for REITs

All schemes seeking authorisation by the Commission must appoint an independent property valuer. Such valuer shall: -

- be a company that carries on the business of valuing properties in Hong Kong;
- have a minimum HK\$5 million paid up capital and sufficient financial resources to carry out its duties;
- have adequate professional insurance coverage;
- be independent of the scheme, its trustee and its management company; and
- retire after it has conducted valuation for the real estate of a REIT for two consecutive years, and not to be eligible for reappointment until two years after such retirement.

A site inspection and valuation of the real estate of a REIT have to be performed on a regulator basis, and otherwise as required by circumstances set out in the proposed Code.

Q8. *Do you agree with the proposed eligibility requirements for the valuer of a REIT? If not, why not?*

(5) Core Investment Requirements

The Commission believes that a well-defined investment policy and transparent operational and management requirements are key to the long-term viability of a REIT. As property investments generally involve substantial capital outlay, a REIT is not subject to the diversification requirement that generally applies to traditional collective investment schemes.

The Commission has deliberated on the issue of geographical exposure and gathered views from market participants. One school of thought recommended that REITs should be initially confined to investments in Hong Kong properties, for the following reasons:

- (a) the REIT concept is new to the investing public in Hong Kong and a cautious approach is warranted;
- (b) the product is easier to understand for retail investors who are already familiar with the Hong Kong real estate market; and
- (c) investors' understanding of the underlying investments is crucial to their exercise of voting rights on major issues (discussed in detail under "(6) Corporate Governance").

On the other hand, others have suggested that REITs should not be restricted to investments in Hong Kong properties for the following reasons:

- (a) investors should be provided with the opportunity to choose the geographical exposure or diversification, according to their own needs;
- (b) the geographical restriction may discourage experienced overseas managers of REITs from participating in REITs in Hong Kong, thus depriving investors' access to the expertise and skills of such professionals; and
- (c) properties in certain emerging markets are attractive because they present high growth potential, although some commentators have cautioned that there could be corporate governance issues.

Having balanced the various arguments, the Commission proposes to initially focus on Hong Kong properties, with an aim to re-examine the geographical limit at a later stage, as the market gains familiarity with the product and the Commission gains further experience in regulating REITs.

In terms of investment restrictions, it is proposed that a REIT shall:

- only invest in real estate in Hong Kong which is income generating;
- have a clear statement regarding its investment policy and its investment objectives;
- distribute 100% of its after tax income as dividend to unit holders;
- not hold non-income generating real estate in excess of 10% of the total net asset value of the scheme;
- not invest in vacant land or property development with the exception of refurbishment and renovation;
- hold its real estate for a period of no less than 2 years unless otherwise approved by its unit holders;
- not engage in investment in hotels or recreation parks which do not generate recurrent rental income;
- not borrow more than 35% of the total net asset value of the scheme; and
- only hold cash or cash equivalent, up to a maximum of 10% of the scheme's total net asset value; and
- return excess cash to unitholders in accordance with the proposed Code requirement.

Q9. Given that the REIT concept is new to the Hong Kong market, the SFC intends to initially restrict the investment scope to real estate in Hong Kong, subject to future review. Do you think that this restriction will dampen the development of REITs in Hong Kong at this stage and if so, why?

Q10. If the Code is to include other geographical locations for investments by REITs, what criteria do you think such locations shall be required to meet in order that investors' interests are safeguarded, and why? Should there be any maximum exposure to non-Hong Kong real estate should a REIT be allowed to invest outside of Hong Kong, and why?

Q11. Should there be a requirement on a minimum initial fund size for a REIT to be viable, given the capital outlay for real estate properties can be

substantial? If so, what would be an appropriate minimum fund size requirement in this case, and why?

Q12. Do you agree that the various proposed investment restrictions, namely, dividend pay-out policy, borrowing restriction, maximum cash holding level and the policy on returning excess cash are appropriate in the context of the Hong Kong market? If not, why not?

Q13. Currently, the Commission has not imposed any diversification requirements on REITs. Do you foresee that there will be any significant risks resulting from the lack of diversification in a REIT's portfolio? If so, what kind of risks?

Q14. It has been suggested that even in the absence of favourable tax treatment, REITs in Hong Kong should be competitive vis-à-vis their counterparts in overseas jurisdictions, given the simple tax system and the low rates of taxes in Hong Kong. Do you agree? Otherwise, what are your reasons for advocating preferential tax treatment?

(6) Corporate Governance of REITs

The Commission believes that a high level of corporate governance is fundamental to building public confidence in any investment product including REITs. The establishment of a trust structure ensures the security of any property owned. As a further step, the Commission proposes several policy requirements to raise the transparency of connected party transactions, to efficiently replace the management company, and to ensure fair and independent valuation of scheme assets.

Transparency in connected persons transaction

The Commission proposes that all transactions carried out by or on behalf of the scheme must be :-

- carried out at arm's length;
- independently valued;
- consistent with the investment objective and strategy of the scheme; and
- in the best interest of the unit holders.

In addition, the Commission proposes to require all connected party transactions to be subject to prior approval of unitholders by way of a special resolution at an EGM, unless the amount involved is below the threshold set out in the proposed Code. For the purpose of such an EGM, unit holders shall be informed of the rationale for and the details of the proposed transaction. In addition, the annual report of a REIT shall also disclose the details of all connected party transactions undertaken in the relevant financial year. In any event, even where such transaction is carried out at arm's length and does not require unitholders' approval, the scheme is still required to notify in writing all unitholders of the nature and details of the transaction.

Q15. Should the management company of a REIT be allowed to invest its own capital in the scheme? If it does, do you foresee any conflicts of interests and how should these conflicts be dealt with?

Q16. Currently, the definition of connected persons to the scheme does not include the scheme's major unitholders and their associates. In the event of a major transaction involving a major unitholder or its associates, do you think that such a transaction should be submitted for prior approval by the unitholders, with the counterparties to the scheme abstaining from voting? If not, why not?

Efficient replacement of management company

The quality of management is central to the overall performance of a REIT. As such, it is important that unitholders have an appropriate degree of oversight with respect to the management company's performance. The Commission proposes that, apart from the bankruptcy of the management company or the withdrawal by the Commission of the registered status of the management company, the management company may also be dismissed by means of an executive order from the trustee in the interest of the unitholders, or upon approval by holders of 75% of the outstanding value of the units.

Fair, timely and independent valuation of schemes assets

Timely and credible valuation of the properties held by a REIT can promote efficient and fair pricing of the units. To achieve this, the Commission proposes that:

- the valuer shall be independent of the trustee of the scheme, its management company and its property management company;
- a valuation certificate shall be produced on a quarterly basis for a listed REIT, and on a semi-annual basis for an unlisted REIT;
- a full valuation report shall be prepared on an annual basis and otherwise as required in circumstances set in the proposed Code; and
- no valuer shall value the same scheme for more than two consecutive years.

In the event where the REIT is terminated, an open auction of the real estate held by the REIT shall be performed and the prevailing available market value shall be used as the minimum open bid price for the purpose of such an auction. This requirement is to ensure that all unit holders will receive their respective share of the fair value of the REIT which is determined by the best possible market prices prevailing at the time of termination.

Q17. Do you agree with the proposed frequency for the valuation of listed and unlisted REITs? If not, why not?

Q18. Do you agree with the liquidation period proposed in the Code upon the termination of a scheme? If not, why not? In your view, what would be an appropriate timeframe for liquidation and why?

Q19. What are other potential corporate governance or conflicts of interest issues that have not been addressed by the proposed Code? What are your proposals to address such issues?

(7) Exit mechanism

In view of the illiquid nature of real estate, it is preferred that a REIT is listed on the Hong Kong Stock Exchange so that investors may divest from or invest in the REIT without impacting the cashflow or operations of the REIT.

Under the existing listing regime in Hong Kong, collective investment schemes can be listed on the Hong Kong Stock Exchange under Chapter 20 of the Listing Rules. The Commission is currently working with the Hong Kong Exchange on means to streamline the listing procedure of a REIT authorized under the proposed Code. In the meantime, it is proposed that a REIT shall provide an annual redemption facility which allows redemption of up to 10% of the outstanding units of the REIT. Such redemption facility can be dispensed with once the REIT is listed.

Q20. Do you believe that having listing status on the Hong Kong Stock Exchange is an important factor in deciding on the viability of a REIT in Hong Kong? If so, why?

Q21. In your view, what are some of the obstacles for listing a REIT on the Hong Kong Stock Exchange?

Q22. Do you believe that it is fair and practicable to allow a non-listed REIT to have an annual redemption facility of up to 10% of the outstanding units of the REIT?

Q23. Apart from listing and creation of redemption / subscription facility, do you think it is desirable to allow for fixed term closed-end REITs as well? If so, why? Are there any other exit alternatives that the Commission should consider?

(8) Disclosures and Financial Reporting

In line with the international trend towards greater transparency, the Commission believes that pertinent disclosure regarding the offering of a REIT and on-going financial reports of a REIT must be provided in a timely and meaningful manner to help investors make informed investment decisions.

The necessary items to be disclosed in the offering documents of a REIT shall include its investment objective and policy, details of the valuation of the real estate held by the REIT, information pertaining to the principal operators, and other operational details.

For each financial year, the Commission proposes that at least two financial reports shall be distributed to the unitholders. In line with the general practices of authorised funds in Hong Kong, the annual report shall be distributed to holders within four

months of the end of the scheme's financial year, and the semi-annual report shall be distributed to holders no later than two months after the end of the relevant period.

The Commission further proposes that the annual report shall include a summary of the REIT management's discussion on investment outlook, a list of connected party transactions that a REIT has undertaken during the year, the top five real estate agents and contractors engaged by a REIT during the year, and a full valuation report and audited financial statements as prescribed in the draft Code.

Regarding the semi-annual report, the Commission proposes that the report shall include, at the very least, the management's discussion of a REIT's performance, strategy and outlook, a list of properties and summary of transactions during the period. In addition, both reports shall include a standardised performance report that states the total net asset value per unit, its highest and lowest net asset value per unit (in the case of a unlisted REIT) or the highest premium or discount to the net asset value per unit (in the case of a listed REIT), and the net yield per unit for the relevant periods.

Q24. Do you think the proposed disclosure and reporting requirements for REITs are sufficient? What other additional disclosures should be required?

Q25. What risk warning statements shall be made in:

- (a) Offering documents?***
- (b) Regular reports?***
- (c) Advertisements and marketing materials?***

Q26. If a guarantee is provided, whether on dividends or capital, what kind of requirements do you think should be imposed, e.g. pledging of assets to the guarantor, amount of guarantee, qualifications of guarantor?

Enclosures

- Annex I - Draft Code on REITs
- Annex II - List of Questions
- Annex III - Overseas Development of REITs

DRAFT CODE ON REAL ESTATE INVESTMENT TRUSTS

Authorization of REITs and its general principles

Explanatory notes

The Securities and Futures Commission ("the Commission") is empowered under section 104(1) of the Securities and Futures Ordinance (Cap. 571) ("SFO") to authorize collective investment schemes, subject to such conditions as it considers appropriate.

This Code on Real Estate Investment Trusts ("the Code") establishes guidelines for the authorization of a collective investment scheme which is a real estate investment trust ("REIT").

The Commission will be empowered under section 105(1) of the SFO to authorize the issue of an advertisement or invitation to the public in Hong Kong to invest in a collective investment scheme, subject to such conditions as the Commission considers appropriate.

The Commission may at any time review its authorization of a REIT, or of an advertisement or invitation relating thereto, and may modify, add to or withdraw any of the conditions of such authorization, or revoke the authorization, as it considers appropriate.

The issue of a false or misleading advertisement or invitation to the public in Hong Kong to invest in an unauthorized collective investment scheme may amount to an offence under s.103(1) of the SFO.

This Code, which will be published in the Gazette, does not have the force of law and shall not be interpreted in a way that will override the provision of any law.

Unless otherwise specified or the context otherwise requires, words and phrases in the Code shall be interpreted by reference to any definition of such word or phrase in Part 1 of Schedule 1 to the SFO.

General Principles

The Commission has modelled the Code on principles developed by the International Organization of Securities Commissions and other principles that the Commission believes to be fundamental for the proper regulation of REITs.

GP1. Clarity of legal form and ownership structure

The assets of a REIT shall be held in a trust and segregated from the assets of its trustee, its management company, its related entities, other collective investment schemes and any other entity.

GP2. Effective oversight by trustee

The trustee shall be functionally independent of the management company of a REIT and shall act in the best interests of unit holders in maintaining the legal integrity of the assets of the REIT.

GP3. Eligible management company

The management company of a REIT shall satisfy the Commission that it possesses the human, technical and financial resources to effectively and responsibly discharge its functions in relation to the REIT, including carrying out its stated investment policy. In this aspect, the management company shall observe high standards of integrity, market conduct and fair dealing. Further, the management company shall not exceed the powers conferred upon it by the constitutive documents of the REIT.

GP4. Delegation of management functions

A REIT management company shall perform all the key functions in relation to the management of the REIT. No management function shall be delegated unless the management company can properly monitor and ensure proper performance by the delegate. Notwithstanding that certain subsidiary functions can be delegated to a third party, the management company remains fully liable to the REIT's unit holders and trustee for the proper performance thereof. The management company shall ensure that a delegate remains competent to undertake the function in question. The legal relationship between the management company and a delegate shall be unambiguous.

GP5. Compliance with relevant requirements

The management company of the REIT shall satisfy the Commission that sufficient systems, controls and procedures are in place to ensure that all applicable regulatory and other legal requirements are complied with. The management company and the trustee of a REIT shall deal with the Commission in an open and co-operative manner.

GP6. Avoidance of conflicts of interest

The management company shall act in the best interests of the REIT's unit holders, to whom it owes a fiduciary duty. Transactions entered into by the management

company for the REIT shall be at arm's length and on normal commercial terms. The management company shall ensure that procedures are in place to ensure that its staff do not enter into transactions for the REIT which may compromise the interests of the REIT's unit holders.

GP7. Asset valuation and pricing

The management company shall ensure that the assets of a REIT are regularly valued in good faith according to market practice or in accordance with procedures that are approved by the Commission, and in accordance with accepted accounting principles. In the case of an unlisted REIT, its units shall be priced based on their net asset value, according to the current valuation of the REIT's assets.

GP8. Investment and borrowing limitations

There shall be investment restrictions and borrowing limitations that take into account the investment objectives, risk profile and liquidity required for a REIT. Such restrictions and limitations shall be disclosed clearly in the offering document of the REIT.

GP9. Investor rights

A REIT shall provide unit holders with a mechanism to withdraw funds from the scheme within a reasonable period of time and without giving an unfair advantage to one unit holder in the REIT over other unit holders. Redemption and management fees shall be disclosed clearly in the offering document. It shall also ensure that unit holders are able to participate in significant decisions concerning the REIT and that unit holders' rights are maintained in the event of a major change in the activities of the REIT.

GP10. Marketing and disclosure

Potential investors and current unit holders in a REIT shall be provided with full, accurate and timely information regarding the REIT in order to enable them to fully understand the investment and risk profile of the REIT and to help them make an informed investment decision. Advertising shall not contain information which is false or misleading nor be presented in a deceptive manner.

Effect of breach of the Code

Failure by any person to comply with any applicable provision of the Code –

- (a) shall not by itself render the person liable to any judicial or other proceedings, but in any proceedings under the SFO before any court, the Code shall be admissible in evidence, and if any provision set out in the Code appears to the court to be relevant to any question arising in the proceedings, it shall be taken into account in determining the question; and
- (b) may cause the Commission to consider whether such failure adversely reflects on the person's fitness and properness and the suitability of the REIT to remain authorized.

Chapter 1: Administrative Arrangements

- 1.1 The Commission has delegated its powers under section 104 of the Securities and Futures Ordinance with respect to REITs to the Committee on REITs, the Executive Director (Intermediaries and Investment Products) and the Director (Investment Products). Where new policy or corporate governance issues in relation to the application of the Code to REITs are considered, the Executive Director or the Director may refer to the Committee on REITs on such issues.
- 1.2 The Committee on REITs is established pursuant to section 8 of the Securities and Futures Ordinance for the purposes of providing the Commission advice on matters relating to REITs.
- 1.3 The constitution of the Committee is to comprise of an Executive Director of the Commission; a non-executive director of the Commission, the Director of Investment Products, and independent third parties who have experience in managing REITs or schemes that operate in a similar manner as REITs, in property management or in corporate governance.
- 1.4 Under section 10(4) of the Securities and Futures Ordinance, the Commission may concurrently perform any function, power or duty which it has delegated but the Commission does not intend to exercise this right by reviewing a decision of the Committee except where there has been:-
 - (a) a manifest error; or
 - (b) an application of defective procedures; or
 - (c) a manifest misinterpretation of this Code.

Data Privacy

- 1.5 The information requested under the Code may result in the applicant providing the Commission with personal data as defined in the Personal Data (Privacy) Ordinance. The data supplied will only be used by the Commission to perform its functions, in the course of which it may match, compare, transfer or exchange personal data with data held or obtained by the Commission, government bodies, other regulatory authorities, corporations, organizations or individuals in Hong Kong or overseas for the purpose of verifying those data. Subject to the limits in sections 378 of the Securities and Futures Ordinance, the Commission may disclose personal data to other regulatory bodies. You may be entitled under the Personal Data (Privacy) Ordinance to request access to or to request the correction of any data supplied to the Commission, in the manner and subject to the limitations prescribed. All enquiries shall be directed to the Data Privacy Officer at the SFC.

Chapter 2: Interpretation

- 2.1 “Approved person” bears the meaning as defined in the Securities and Futures Ordinance for “approved person” in relation to a collective investment scheme.
- 2.2 “Associate” bears the meaning as defined in the Securities and Futures Ordinance for “associate” of a person.
- 2.3 “Associated company”. A company shall be deemed to be an associated company of another company if one of them owns or controls 20% or more of the voting rights of the other or if both are associated companies of the same company.
- 2.4 “Collective investment scheme” bears the meaning as stated in Schedule 1 of the Securities and Futures Ordinance.
- 2.5 “Commission” or “SFC” refers to the Securities and Futures Commission as stated in s.3 of the Securities and Futures Ordinance.
- 2.6 “Committee” means the Committee on REITs.
- 2.7 “Constitutive documents” means the principal documents governing the formation of the scheme, and includes the trust deed and all material agreements.
- 2.8 “Controlling entity” bears the meaning as defined in the Securities and Futures Ordinance for “controlling entity”, other than (a)(ii) in its definition.
- 2.9 “Holder” in relation to an unit in a scheme means the person who is entered in the register as the holder of that unit or the bearer of a bearer certificate representing that unit.
- 2.10 “Institute” means The Hong Kong Institute of Surveyors.
- 2.11 “Management company” means the entity appointed pursuant to Chapter 5 of this Code and includes its delegate where applicable.
- 2.12 “Offering document” means that document, or documents issued together, containing information on a scheme to invite offers by the public to buy units in the scheme.
- 2.13 “Scheme” means a REIT authorized under this Code.
- 2.14 “Special resolution” by holders of a scheme may only be passed by 75% or more of the votes of those present and entitled to vote in person or by proxy at a duly convened meeting and the votes shall be taken by way of poll.

- 2.15 “Substantial financial institution” means a licensed banking institution authorized under the Banking Ordinance or financial institution with a minimum paid-up capital of HK\$150,000,000 or its equivalent in foreign currency.
- 2.16 “Trustee” means the entity appointed pursuant to Chapter 4 of this Code.

Chapter 3: Basic Requirements for the authorization of a REIT

What is a REIT

- 3.1 A REIT is a collective investment scheme constituted as a trust that invests primarily in real estate with a view to providing returns to unit holders derived from the rental income of the real estate as well as gains calculated by reference to any appreciation in the value of its real estate holdings. Funds obtained by a REIT from the sale of units in the REIT are used in accordance with the REIT's constituting documents to maintain, manage and add to its portfolio of real estate.

Requisite conditions for REIT authorization

- 3.2 A REIT seeking authorization from the Commission has to have the following characteristics: -
- (a) dedicated investments in real estate that generates recurrent rental income;
 - (b) active trading of real estate is restricted;
 - (c) the greater proportion of income must be derived from rentals of real estate;
 - (d) a significant portion of income is distributed to units holders in the form of regular dividends;
 - (e) a maximum borrowing limit is defined; and
 - (f) connected party transactions will be subject to unit holders' approval

Chapter 4: Trustee

Appointment of Trustee

- 4.1 Every scheme for which authorization is requested shall be structured as a trust and appoint a trustee acceptable to the Commission.

Note: This chapter lists the general obligations of the trustees. Trustees are expected to fulfill the duties imposed on them by the general law of trusts.

General Obligations of Trustee

- 4.2 The trustee shall:-
- (a)
 - (i) exercise all due diligence and vigilance in carrying out its functions and duties and in protecting the rights and interests of the holders;
 - (ii) ensure that all the assets of the scheme are properly segregated and held for the benefit of the holders in accordance with the provisions of the constitutive documents; and
 - (iii) be liable for the acts and omissions of its nominees and agents in relation to assets forming part of the property of the scheme.
 - (b) take reasonable care to ensure that the sale, issue, repurchase, redemption and cancellation of units effected by a scheme are carried out in accordance with the provisions of the constitutive documents;
 - (c) appoint from time to time a property valuer who meets the qualification requirements set out in Chapter 6 to value the real estate of the scheme, and take reasonable care to ensure that the valuation methods adopted by the property valuer are reasonable and fair;
 - (d) cause a valuation of any of the real estate of the scheme to be carried out if it, or the management company, reasonably believes that there has been a significant change in the value of the real estate, and in any event, valuation certificates and a full valuation report with respect to the properties of the scheme have to be produced in accordance with Chapter 6;
 - (e) ensure that the sale, issue, repurchase, redemption and cancellation prices are calculated in accordance with the provisions of the constitutive documents;
 - (f) carry out the instructions of the management company in respect of investments unless they are in conflict with the provisions of the offering or constitutive documents or this Code;

- (g) take reasonable care to ensure that the investment and borrowing limitations set out in the constitutive documents and the conditions under which the scheme was authorized are complied with;
- (h) ensure that no real estate is acquired or disposed of by or on behalf of the trustee until the trustee has obtained the valuation report of a property valuer appointed and instructed in writing by the trustee;
- (i) ensure that all transactions are carried out by or on behalf of a scheme are conducted at arm's length and that connected party transactions are carried out in accordance with Chapter 8;

Note: Where the trustee is in doubt as to whether a transaction is connected party transaction, it shall require such transaction to be subject to the provisions of Chapter 8.

- (j) issue a report to the holders to be included in the annual report on whether in the trustee's opinion, the management company has in all material respects managed the scheme in accordance with the provisions of the constitutive documents; if the management company has not done so, the respects in which it has not done so and the steps which the trustee has taken in respect thereof;
- (k) take reasonable care to ensure that unit certificates are not issued until subscription moneys have been paid;
- (l) ensure that a scheme has proper legal titles to the real estate owned by the scheme, as well as to the contracts (such as rental agreements) entered on behalf of the scheme with respect to its assets and all such contracts shall be legal, valid and binding and enforceable by or on behalf of the scheme in accordance with its terms;

Note: The real estate shall have a good root title or a good marketable title.

- (m) ensure that all transactions carried out for or on behalf of a scheme are in the best interest of the holders;

Note: The trustee may seek the opinion of an independent financial adviser or such other professional adviser if it deems appropriate.

- (n) ensure that there is adequate property insurance and public insurance coverage over the real estate of a scheme; and
- (o) ensure that the net asset value per unit of the scheme is calculated as and when a valuation certificate or an annual valuation report is prepared by the valuer for the relevant period, and such net asset value shall be published in accordance with 10.7.

Criteria for Acceptability of a Trustee

- 4.3 A trustee shall be:-
- (a) a bank licensed under Section 16 of the Banking Ordinance; or
 - (b) a trust company which is a subsidiary of such a bank; or
 - (c) a banking institution or trust company incorporated outside Hong Kong which is acceptable to the Commission.
- 4.4 A trustee shall be independently audited and have minimum issued and paid-up capital and non-distributable capital reserves of HK\$10 million or its equivalent in foreign currency.
- 4.5 Notwithstanding 4.4 above, the trustee's paid-up capital and non-distributable capital reserves may be less than HK\$10 million if the trustee is a wholly-owned subsidiary of a substantial financial institution (the holding company); and
- (a) the holding company issues a standing commitment to subscribe sufficient additional capital up to the required amount, if so required by the Commission; or
 - (b) the holding company undertakes that it would not let its wholly-owned subsidiary default and would not, without prior approval of the Commission, voluntarily dispose of, or permit the disposal or issue of any share capital of the trustee such that it ceases to be a wholly-owned subsidiary of the holding company.
- 4.6 The trustee shall have the knowledge and at least three years of relevant experience in holding real estate under a scheme that operates in a similar manner as a REIT authorized under this Code.

Retirement of Trustee

- 4.7 The trustee shall not retire except upon the appointment of a new trustee and subject to the prior approval of the Commission. The retirement of the trustee shall take effect at the same time as the new trustee takes up office.

Independence of Trustee and the Management Company

- 4.8 The trustee and the management company shall be independent of each other.
- 4.9 Notwithstanding 4.8 above, if the trustee and the management company are both body corporates having the same ultimate holding company, whether incorporated in Hong Kong or outside Hong Kong, the trustee and the management company are deemed to be independent of each other if:-
- (a) they are both subsidiaries of a substantial financial institution;

- (b) neither the trustee nor the management company is a subsidiary of the other;
- (c) no person is a director of both the trustee and the management company;
- (d) both the trustee and the management company sign an undertaking that they will act independently of each other in their dealings with the scheme; and
- (e) the ultimate holding company submits a declaration and an undertaking to the Commission that the trustee and the management company are, and that the ultimate holding company shall ensure that they continue to be, independent of each other, other than due to their relationship with each other as member companies in the same group.

Chapter 5: Management Company and Auditor

Appointment of a Management Company

- 5.1 Every scheme for which authorization is requested shall appoint a management company acceptable to the Commission.

General Obligations of a Management Company

- 5.2 A management company shall:-

- (a) manage the scheme in accordance with the scheme's constitutive documents in the exclusive interest of the holders. It is also expected to fulfill the duties imposed on it by the general law;
- (b) ensure that the financial and economic aspects of the assets of the scheme are professionally managed in the sole interest of the holders; including:
 - (i) formulating the investment strategy and policy of the scheme;
 - (ii) determining the borrowing limit of the scheme;
 - (iii) investing in properties that meet the investment objective of the scheme;
 - (iv) managing the cashflows of the scheme;
 - (v) managing the financial arrangements of the scheme;
 - (vi) formulating dividend payment schedule of the scheme;
 - (vii) planning the tenant mix and identifying potential tenants;
 - (viii) formulating and implementing the leasing strategy;
 - (ix) enforcing tenancy conditions;
 - (x) ensuring compliance with government regulations in respect of the properties under management;
 - (xi) performing tenancy administration work, such as managing tenant occupancy and ancillary amenities, negotiate with tenants on grant, surrender, rent review, renewal of lease, termination and re-letting of premises;
 - (xii) conducting rental assessment, formulating tenancy terms, preparing tenancy agreements, rent collection, accounting, recovery of arrears and possession;
 - (xiii) administering routine management services, including security control, fire precautions, communication systems and emergency management;
 - (xiv) formulating and implementing policies and programmes in respect of building management, maintenance and improvement; and
 - (xv) initiating refurbishment and monitoring such activity.
- (c) maintain or cause to be maintained the books and records of the scheme in Hong Kong and prepare the scheme's accounts and reports. At least two reports shall be published in respect of each financial year. These

reports shall be sent to all registered holders and filed with the Commission within the time frame specified in 10.7; and

- (d) ensure that the constitutive documents, financial reports, circulars and notices, valuation certificates and valuation reports of the scheme are made available for inspection by the public in Hong Kong, free of charge at all times during normal office hours at its place of business and that of its approved person and make copies of such documents available upon the payment of a reasonable fee.

Criteria for Acceptability of Management Company

- 5.3 A management company shall be licensed by the Commission to manage collective investment schemes. Such entity shall delegate the functions of property management, namely those relating to the day-to-day maintenance of the real estate owned by the scheme, including functions under 5.2(vii) to (xv).

Note: The Commission may consider a management company which is licensed by an overseas securities regulator to conduct business similar to that carried out by the scheme. There shall be a memorandum of understanding between the overseas regulator and the Commission so that the activities of the management company are subject to regulatory oversight. Such overseas management company shall demonstrate to the satisfaction of the Commission that it generally meets the requirements imposed on a management company under this Code and it is experienced with the property market of Hong Kong.

- 5.4 The management company shall:

- (a) be engaged primarily in the business of fund management;

Notes: (1) The management company shall have at least five years' track record in managing public funds and conducting such functions as it purports to perform in relation to the scheme.

(2) The Commission may consider a management company with fewer years of experience if it belongs to a management group that has an established record of managing schemes that operate in a similar manner as REITs authorized under this Code.

- (b) have at least two key personnel, each with at least five years of experience in analyzing the property market in Hong Kong or advising on property investment in Hong Kong, including two years of experience with respect to the type of properties proposed by the scheme.

- (c) demonstrate that it has proper due diligence procedures in place for the selection and ongoing monitoring of the delegate to whom it shall delegate the functions of property management;

Note: The Commission may request the submission of the resumes of the key personnel of the management company and the due diligence procedures with respect to selection and supervision of its delegates.

- (d) demonstrate that it has sufficient financial resources at its disposal to enable it to conduct its business effectively and meet its liabilities; in particular, it shall have a minimum issued and paid-up capital and capital reserves of HK\$1 million or its equivalent in foreign currency;
- (e) not lend to a material extent; and
- (f) maintain at all times a positive net asset position.

5.5 Indebtedness owed by the management company to its parent company will be considered as part of capital for the purpose of 5.4 in the following circumstances:-

- (a) the indebtedness shall not be settled without the prior written consent of the Commission; and
- (b) the indebtedness shall be subordinated to all other liabilities of the management company, both in terms of its entitlement to income and its rights in a liquidation.

5.6 The management company shall ensure that its delegate has experience and sufficient financial resources at its disposal to enable it to conduct its business and meet its liabilities.

Notes: (1) The management company shall ensure that its delegate is fit and proper. This includes ensuring that the delegate is a company with good and established reputation in performing such duties, has sufficient resources to carry out its duties, has key personnel who are professionally qualified to manage properties and who have at least five years of experience in managing properties, including at least two years in managing both properties of the same type and a property portfolio of a similar size as the scheme. Such delegate shall also be financially sound with a positive net asset position, and has acquired sufficient professional insurance to cover usual risks.

- (2) *The management company shall be entitled to inspect and the delegate shall make available for inspection any books and records kept by the delegate in relation to the real estate managed by it under the scheme.*

- 5.7 All transactions carried out by or on behalf of the scheme shall be at arm's length. In particular, any transactions between the scheme and the management company or any other connected persons to the scheme as principal may only be made in accordance with Chapter 8. All such transactions shall be disclosed in the scheme's annual report.
- 5.8 The Commission shall be satisfied with the overall integrity of the management company. Reasonable assurance shall be secured of the adequacy of internal controls and the existence of written procedures, which shall be regularly monitored by the management company's senior management for updatedness and compliance. Conflicts of interests shall be properly addressed to safeguard investors' interests.
- 5.9 The management company shall at all times maintain on-going supervision and regular monitoring of the competence of its delegate to ensure that the management company's accountability to investors is not diminished or compromised. Although the role of the management company may be delegated or sub-contracted to third parties, the responsibilities and obligations of the management company may not be delegated and shall remain the responsibilities and obligations of the management company.

Retirement of a Management Company

- 5.10 The management company shall be removed by notice in writing from the trustee in any of the following events:-
- (a) the management company goes into liquidation, becomes bankrupt or has a receiver appointed over its assets or any part thereof; or
 - (b) for good and sufficient reason(s), the trustee states in writing that a change in management company is desirable in the interests of the holders; or
 - (c) holders representing at least 75% in value of the units outstanding (excluding those held or deemed to be held by the management company), deliver to the trustee a written request to dismiss the management company.
- 5.11 In addition, the management company shall retire:-
- (a) in all other cases provided for in the constitutive documents; or
 - (b) when the Commission withdraws its approval of the management company.
- 5.12 The Commission shall be informed forthwith by the trustee of any decision to remove the management company.

- 5.13 Upon the retirement or dismissal of the management company, the trustee shall appoint a new management company as soon as possible, subject to the approval of the Commission.
- 5.14 Notwithstanding the removal or retirement of the management company, the delegate which is the property manager of the real estate of the scheme shall remain so, unless:
- (a) the trustee states in writing that a change in this delegate is desirable and in the interest of the holders; or
 - (b) holders representing at least 75% in value of the units outstanding (excluding those held or deemed to be held by the management company), deliver to the trustee a written request to dismiss the delegate; or
 - (c) the replacement management company has identified another delegate to perform the property management function.

Appointment of the Auditor

- 5.16 The management company shall, at the outset and upon any vacancy, appoint an auditor for the scheme.
- 5.17 The auditor shall be independent of the management company and the trustee.
- 5.18 The management company shall cause the scheme's annual report to be audited by the auditor, and such report shall contain the information in Appendix B.

Chapter 6: Property Valuer

Appointment of a Property Valuer

- 6.1 Every scheme for which authorization is requested shall appoint an independent property valuer acceptable to the Commission.

General Obligations of a Property Valuer

- 6.2 A property valuer shall value all the real estate held under the scheme, on the basis of a full valuation with physical inspection in respect of the site of the real estate and an inspection of the building(s) and facilities erected therein at least once a year, and in any event for the purposes of redemption or issuance of new units. The contents of the valuation report shall comply with 6.7. The valuer shall also produce a valuation certificate on all properties held by the scheme on a regular basis.

Notes: (1) A valuation certificate shall be produced on a quarterly basis for a listed REIT, and on a semi-annual basis for an unlisted REIT.

(2) The valuation certificate shall at least contain:

- (a) the address of each of the properties;*
- (b) a description of the tenure of each of the properties;*
- (c) particulars of the occupancy of each of the properties; and*
- (d) valuation of each of the properties.*

- 6.3 The valuation methodology shall follow the “Hong Kong Guidance Notes on the Valuation of Property Assets” published by the Hong Kong Institute of Surveyors;

Criteria for Acceptability of Property Valuer

- 6.4 A property valuer shall be a company that:
- (a) provides property valuation service on a regular basis;
 - (b) carries on the business of valuing properties in Hong Kong;
 - (c) have key personnel who are fellow or associate members of the Hong Kong Institute of Surveyors;
 - (d) has sufficient financial resources at its disposal to enable it to conduct its business effectively and meet its liabilities; in particular, it shall have a minimum issued and paid-up capital and capital reserves of HK\$5 million or its equivalent in foreign currency; and
 - (e) has adequate professional insurance to cover its usual risks.
- 6.5 The valuer shall be independent of the scheme, the trustee and the management company of the scheme. The valuer is not considered independent if:-
- (a) it is the subsidiary or holding company of:

- (i) the management company of the scheme;
 - (ii) the trustee of the scheme; or
 - (iii) the holding company, subsidiary or associated company of the scheme's management company or the scheme's trustee; or
- (b) any of its partners, directors or officers is an officer or servant or director or an associate of:
- (i) the management company of the scheme;
 - (ii) the trustee of the scheme; or
 - (iii) the holding company, subsidiary or associated company of the scheme's management company or the scheme's trustee; or
- (c) in the case where the scheme intends to acquire or dispose of a property (the "subject property"), the valuer or its associate:
- (i) is engaged whether as a principal or agent by the scheme's counter party in relation to the introduction or referral of the scheme to the subject property or vice versa; or
 - (ii) is engaged whether as a principal or agent by the scheme in relation to the acquisition of the subject property; or
 - (iii) acts as a broker for the property transaction for a fee; or
 - (iv) had, at any time during the two years immediately before the date of the agreement for such intended purchase or disposal, been retained to provide valuation on the subject property to the scheme's counter party (and its associated companies) that intends or has agreed to sell to or purchase from the scheme the subject property.

Qualifications of Directors

- 6.6 The directors of the property valuer shall be persons of good repute who in the opinion of the Commission possess the necessary experience for the performance of their duties. They shall be corporate members of the Institute.

Valuation Report

- 6.7 The property valuer shall produce a valuation report which shall include at a minimum:
- (a) all material details in relation to the basis of valuation and the assumptions used;
 - (b) the following particulars in respect of each property, such as:
 - (i) an address sufficient to identify the property, which shall generally include postal address, lot number and such further designation as is registered with the appropriate government authorities in the jurisdiction in which the property is located;

- (ii) the nature of the interest the scheme holds in the property (e.g. if it is a freehold or leasehold, and the remainder of the term if it is a leasehold);
 - (iii) the existing use (e.g. shops, offices, factories, residential, etc.);
 - (iv) a brief description of the property, such as the age of the building, the site area, gross floor area, net lettable floor area, and the current zoning use;
 - (v) the options or rights of pre-emption and other incumbrances concerning or affecting the property;
 - (vi) the occupancy rate;
 - (vii) lease cycle duration;
 - (viii) lease expiry profile;
 - (ix) a summary of the terms of any sub-leases or tenancies, including repair obligation, granted to the tenants of the property;
 - (x) the capital value in existing state at the date the valuation was performed;
 - (xi) the existing monthly rental before profits tax if the property is wholly or partly let together with the amount and a description of any outgoings or disbursements from the rent, and, if materially different, the estimated current monthly market rental obtainable, on the basis that the property was available to let on the effective date as at which the property was valued;
 - (xii) the estimated current net yield;
 - (xiii) a summary of any rent review provisions, where material;
 - (xiv) the amount of vacant space, where material; and
 - (xv) any other matters which may affect the property or its value;
- (c) a letter stating the independent status of the valuer and that the valuation report is prepared on a fair and unbiased basis.

6.8 Whenever a valuation report is prepared for the scheme, the date of the valuation report shall be:

- (a) the date the scheme is valued, if such report is prepared for the purpose of calculating the net asset value of the scheme; or
- (b) the date a circular is issued, if such report is prepared for the purpose of a circular to be issued to unitholders under Chapter 8, regarding a proposed property transaction with connected persons, or Chapter 11, regarding termination or merger.

Retirement of a Property Valuer

6.9 The valuer shall retire after it has conducted valuation for the real estate of the scheme for two consecutive years. Furthermore, the same valuer may only be re-appointed after another two years.

6.10 The property valuer shall be subject to removal by notice in writing from the trustee in any of the following events:

- (a) the property valuer goes into liquidation, becomes bankrupt or has a receiver appointed over its assets; or
- (b) for good and sufficient reason, the trustee states in writing that a change in the property valuer is desirable in the interests of the holders; or
- (c) a special resolution is passed by the holders to dismiss the property valuer.

6.11 In addition, the property valuer shall retire in all other cases provided for in the constitutive documents.

6.12 Upon the retirement or dismissal of the property valuer, the trustee shall appoint a new property valuer that meets the qualification requirements of this chapter.

Chapter 7: Investment Limitations and Dividend Policy

Core Requirements

7.1 The scheme shall only invest in real estate in Hong Kong.

Notes: (1) “Real estate” refers to land or buildings, whether the interest is a freehold or leasehold interest, and includes carpark and assets incidental to the ownership of real estate (e.g. furniture, fittings, fixtures, etc).

(2) The scheme shall make direct investments in real estate.

(3) The real estate shall generally be income-generating.

(4) The scheme may acquire incomplete units in a building which is unoccupied and non-income producing or in the course of substantial development, redevelopment or refurbishment, but the aggregate contract value of such properties shall not exceed 10% of the total net asset value of the scheme at all times.

(5) Real estate such as hotels or recreation parks which do not generate recurrent rental income is not allowed.

(6) A scheme may hold cash or cash equivalent, up to a maximum of 10% of the scheme’s total net asset value.

7.2 The scheme shall hold each of its real estate for a period of at least two years, unless the scheme has clearly communicated to its holders the rationale for disposal prior to this minimum holding period and its holders have given their consent to such sale by way of a special resolution at a general meeting.

7.3 Subject to 11.7 in the case where the scheme does not comply with the cash level requirement of the Code, whether as a result of fund raising activities on sale of properties, the scheme shall return the excess cash to holders within 3 months from the anniversary date of such breach.

7.4 The scheme is prohibited from investing in vacant land or engaging or participating in property development activities. For this purpose, property development activities do not include refurbishment, retrofitting and renovations.

7.5 A scheme may not lend, assume, guarantee, endorse or otherwise become directly or contingently liable for or in connection with any obligation or indebtedness of any person nor shall it use any assets of the scheme to secure the indebtedness of any person nor shall it use any assets of the scheme to secure any obligations, liabilities or indebtedness without the prior written consent of the trustee/custodian.

- 7.6 A scheme may not acquire any asset which involves the assumption of any liability that is unlimited.

Limitations on Borrowing

- 7.7 A scheme may borrow for investment or operating purposes but aggregate borrowings shall not at any time exceed 35% of the total net asset value of the scheme. The scheme may pledge its assets to secure such borrowings. The scheme shall disclose in its offering document its borrowing policy, including its maximum borrowing limit, and the basis for calculating such limit.

Notes: (1) In the event that the limit is exceeded, the scheme is not required to involuntarily dispose of assets to pay off part of the borrowings. However, no further borrowing is permitted.

(2) All borrowings shall be conducted at arms length and the terms shall be commensurate with transactions of similar size and nature.

Name of Scheme

- 7.8. If the name of the scheme indicates a particular type of real estate, the scheme shall invest at least 70% of its non-cash assets in such real estate.

Dividend Policy

- 7.9 The scheme shall distribute as dividend 100% of its net after tax income each year.

Chapter 8: Transactions with Connected Persons

Connected Persons

8.1 Connected persons to the scheme include:

- (i) the management company of the scheme;
- (ii) the property valuer of the scheme;
- (iii) the trustee of the scheme;
- (iv) a director, senior executive or an officer of any of the entities in 8.1 (i), (ii) or (iii) above;
- (v) an associate of the persons in 8.1(iv); or
- (vi) controlling entity, holding company, subsidiary or associated company of any of the entities in 8.1 (i) to (iii).

If the proximity of the commercial interest between a person and the scheme or the persons described in 8.1 above is sufficiently close to be regarded as a connected person to the scheme, the trustee shall, in order to avoid any doubt, ensure the management company and the scheme follow the provisions applicable to connected party transactions as described in this Chapter.

8.2 If cash forming part of the scheme's assets is deposited with the trustee, the management company, the property valuer of the scheme or with any other connected persons (being an institution licensed to accept deposits), interest shall be paid on the deposit at a rate not lower than the prevailing commercial rate for a deposit of that size and term. The same principle applies to the scheme's borrowings from the trustee, the management company, the property valuer of the scheme or any other connected persons (being an institution licensed to lend money).

8.3 All transactions carried out by or on behalf of the scheme shall be:

- (a) carried out at arms-length;

Note: The management company shall ensure that all transactions are carried out in an open and transparent manner. Where circumstances permit, transactions shall be carried out by way of open tender or competitive bidding by auction;

- (b) valued, in relation to a property transaction, by an independent valuer that meets the requirements of Chapter 6;
- (c) consistent with the investment objectives and strategy of the scheme; and
- (d) in the best interests of holders.

8.4 Connected party transactions in real estate relating to a scheme are not required to seek holders' prior approval if:

- (a) the total consideration or value of the transaction is less than the lower of either HK\$ 10,000,000 or 5 per cent of the latest net asset value of the scheme, as disclosed in the latest published audited accounts, and adjusted for any subsequent transactions since the publication of such accounts; and

Note: Where more than one transaction is conducted with the same connected person and the value of this single transaction does not exceed the HK\$10m or 5% limit, the limit applies to the cumulative value of all the transactions between such persons and the scheme during the twelve months preceding the intended transaction.

- (b) the scheme has not entered into any other transactions with a connected person during the financial year that the transaction is agreed upon, in which case, the scheme is only required to serve notice on holders, incorporating the relevant information as set out in Appendix D.

- 8.5 Connected party transactions that do not meet the criteria in 8.4 shall seek holders' prior approval by way of a special resolution passed in an extraordinary general meeting (EGM). A circular containing the information set out in Appendix D shall be sent to holders at least 21 days before the day of the EGM. The EGM shall be conducted in accordance with 9.11 and a notice shall be sent to holders to inform them of the result of the EGM.

Note: Special resolution is required for the approval of a connected party transaction, in accordance with 9.11(j). Any connected persons who are interested in the transaction tabled for approval shall abstain from voting at the EGM.

- 8.6 Connected party transactions in the nature of services provided to the real estate of the scheme in the ordinary and usual course of estate management, such as renovation and maintenance work, shall be contracted on normal commercial terms and subject to the approval of the trustee.

Note: Where the service to be contracted with the connected party is of a stand alone or one-off nature, and the contracted value exceeds 15% of the aggregate value that the scheme committed to or spent on services relating to the real estate of the scheme during the preceding twelve months, prior approval by holders by way of a special resolution passed in an EGM is required, unless the service to be contracted is procured under a public tender. A circular describing the nature and value of the service, as well as the name of the connected person, shall be sent to holders 21 days prior to the EGM. A notice shall be sent to holders after the EGM to inform them of the results of the EGM.

- 8.7 Neither the management company, the property valuer of the scheme nor any other connected persons to the scheme may retain cash or other rebates from a property agent whether in consideration of referring transactions in scheme property to the property agent or otherwise.
- 8.8 Except for the management company in discharging their functions under Chapter 5, the scheme shall not engage connected persons as property agents for rendering services to the scheme, including advisory or agency services in property transactions.
- 8.9 The nature and the value of all connected party transactions have to be disclosed in the annual report of the scheme, and where applicable, the semi-annual report.

Chapter 9: Operational Requirements

Scheme Documentation

Matters to be Disclosed in Offering Document

- 9.1 Authorized schemes shall issue an up-to-date offering document, containing information necessary for investors to be able to make an informed judgement of the investment proposed to them, and in particular containing the information listed in Appendix A.

English and Chinese Documentation

- 9.2 All the circulars, notices, offering documents, valuation certificates and valuation report in relation to the scheme shall be provided in the English and Chinese languages.

Accompaniment to Offering Document

- 9.3 The offering document shall be accompanied by:
- (a) the scheme's most recent audited annual report and accounts;
 - (b) the scheme's semi-annual report if published after the annual report; and
 - (c) a valuation report prepared by a property valuer that meets the qualification requirements stated in Chapter 6. Such report shall be dated the same as that of the offering document and shall comply with the valuation report requirements of Chapter 6.
- 9.4 No application form may be supplied to any person not a holder unless accompanied by the offering document, except that an advertisement or report containing all the requirements of Appendix A may be allowed to incorporate an application form.

Inclusion of Performance Data

- 9.5 The offering document may disclose the rental yield actually achieved by the real estate at the time the valuation report was made. However, such yield does not constitute a forecast of the dividend yield of the scheme. No forecast of the scheme's dividend yield is permitted.

Contents of Constitutive Documents

- 9.6 The constitutive documents of a scheme shall contain the information listed in Appendix C. Nothing in the constitutive documents may provide that the trustee or management company can be exempted from any liability to holders imposed under Hong Kong law or breaches of trust through fraud or negligence, nor may they be indemnified against such liability by holders or at holders' expense.

Changes to Scheme Documentation

- 9.7 The constitutive documents may be altered by the management company and trustee, without consulting holders, provided that the trustee certifies in writing that in its opinion the proposed alteration:-
- (a) is necessary to comply with fiscal or other statutory or official requirements; or
 - (b) does not materially prejudice holders' interests, does not to any material extent release the trustee, management company or any other person from any liability to holders and does not increase the costs and charges payable from the scheme property; or
 - (c) is necessary to correct a manifest error.

In all other cases no alteration may be made except by a special resolution of holders or the approval of the Commission.

Member Register

- 9.8 The trustee or the person so appointed by the trustee shall maintain a register of holders. The Commission shall be advised on request of the address(es) where the register is kept.

Pricing of Initial Offers of Units

Initial Offers

- 9.9 If an initial offer is made, no investment of subscription money can be made until the conclusion of the first issue of units at the initial price.

Pricing

- 9.10 Offer prices shall be calculated on the basis of the scheme's net asset value divided by the number of units outstanding. The values of the real estate shall be those contained in a valuation report that comply with 9.3(b). The net asset value of the scheme may be adjusted by fees and charges, provided the amount or method of calculating such fees and charges is clearly disclosed in the offering document.

Meetings

- 9.11 A scheme shall arrange to conduct general meetings of holders as follows:-
- (a) Holders shall be able to appoint proxies;
 - (b) Votes shall be proportionate to the number of units held or to the value of units held where there are accumulation units;

- (c) The quorum for meetings at which a special resolution is to be considered shall be the holders of 25% of the units in issue and 10% if only an ordinary resolution is to be considered;
- (d) If within half an hour from the time appointed for the meeting a quorum is not present, the meeting shall be adjourned for not less than 15 days. The quorum at an adjourned meeting will be those holders present at the adjourned meeting in person or by proxy;
- (e) If the possibility exists of a conflict of interest between different classes of holders there shall be provision for class meetings;
- (f) Where bearer units are in issue, provision shall be made for notification to bearer holders in Hong Kong of the timing and agenda of forthcoming meetings and voting arrangements;
- (g) Connected persons to the scheme shall be prohibited from voting their beneficially owned units at, or counted in the quorum for, a meeting at which they have a material interest in the business to be contracted;
- (h) An ordinary resolution may be passed by a simple majority of the votes of those present and entitled to vote in person or by proxy at a duly convened meeting;
- (i) A special resolution may only be passed by 75% or more of the votes of those present and entitled to vote in person or by proxy at a duly convened meeting and the votes shall be taken by way of poll.
- (j) An Extraordinary General Meeting shall be called for the following purposes, subject to special resolution:
 - (i) to dismiss the property valuer in accordance with 6.10(c);
 - (ii) to dispose of properties as described in 7.2;
 - (iii) to transact with connected persons to the scheme, except for transactions described in Chapter 8.4;
 - (iv) to modify, alter or add to the constitutive documents, except as provided in 9.7;
 - (v) to terminate or merger the scheme as provided in Chapter 11;
 - (vi) to issue new units in accordance with 12.6;
 - (vii) to change the timing of redemption period as provided in 12.4;
 - (viii) to increase the maximum fees paid to the management company, its delegate, the property valuer of the scheme, or the trustee; or

(ix) to impose other types of fees.

Fees

9.12 The level/basis of calculation of all costs and charges payable from the scheme's property shall be clearly stated, with percentages expressed on a per annum basis (see Appendix A). The aggregate level of fees for investment management or property management functions shall also be disclosed.

Note: Percentage-based transaction fees payable to the management company or any of its connected persons may be disallowed as being inconsistent with the management company's fiduciary responsibility.

9.13 If performance fee is levied, the fee can only be payable:

- (a) no more frequently than annually; and
- (b) if the net asset value per unit exceeds the net asset value per unit on which the performance fee was last calculated and paid (i.e. on a “high-on-high basis”).

9.14 The following fees, costs and charges shall not be paid from the scheme's property:-

- (a) commissions payable to sales agents arising out of any dealing in units of the scheme;
- (b) expenses arising out of any advertising or promotional activities in connection with the scheme;
- (c) expenses which are not ordinarily paid from the property of schemes authorized in Hong Kong; and
- (d) expenses which have not been disclosed in the constitutive documents as required by Appendix C.

Chapter 10: Documentation and Reporting

Changes to Documentation

- 10.1 All proposed alterations or additions to the offering or constitutive documents shall be submitted to the Commission for prior approval. The Commission will determine whether holders shall be notified and the period of notice (if any) that shall be applied before the changes take effect. Such notice period would not normally exceed three months.

Notices to Holders

- 10.2 Notification to holders shall be made in respect of any changes or proposed changes to the offering or constitutive documents as determined by the Commission pursuant to 10.1.

Note: In the case of schemes domiciled outside Hong Kong, notwithstanding the notice provisions of a scheme's home jurisdiction, the Commission may require additional notice to ensure that Hong Kong investors have sufficient time to consider and respond to the documentation.

- 10.3 Notices shall be sent to holders as soon as reasonably applicable, to inform the holders of :
- (a) details of all transactions in respect of real estate, unless the value of the transaction is less than the lower of HK\$10,000,000 or 5 per cent of the gross asset value of the scheme, and is not a connected party transaction;
 - (b) details of all transactions in respect of services performed in relation to the real estate of the scheme, unless the value of the transaction is not more than 15% of the aggregate value of such services contracted during the twelve months preceding the relevant transaction and is not a connected party transaction; or
 - (c) any significant changes in shareholding structure.

Increase in Fees

- 10.4 In respect of any increase of the management fee from the current level as stated in the Hong Kong Offering Document up to the maximum level permitted by the constitutive documents, at least three months prior notice shall be given to all holders.

De-authorization

- 10.5 Following the authorization of a scheme, its management company shall, subject to 10.6 below, give at least three months' notice to holders of any intention not to maintain such authorization. Such notice shall be submitted to the Commission for prior approval and contain reasons for the de-

authorization and the alternatives available to investors in the event of de-authorization.

Reporting Requirements

Reporting to Holders

- 10.6 At least two reports shall be published in respect of each financial year. Annual reports and accounts shall be published and distributed to holders within four months of the end of the scheme's financial year and semi-annual reports shall be published and distributed to holders within two months of the end of the period they cover. The contents of the annual reports and semi-annual reports shall comply with the requirements set out in Appendix B.
- 10.7 The scheme's latest available quarterly net asset value per unit, in the case of a listed REIT, or semi-annual net asset value per unit, in the case of an unlisted REIT, and the annual audited net asset value per unit shall be published in at least one leading Hong Kong English language and one Chinese language daily newspaper.

Reporting to Commission

- 10.8 Subsequent to the authorization of the scheme, all financial reports produced by or for the scheme, its management company and trustee shall be filed with the Commission within the time frame specified in 10.6.
- 10.9 The management company shall supply to the Commission, upon request, all information relevant to the scheme's financial reports and accounts.
- 10.10 The management company shall notify the Commission as soon as possible of any change to the data in the application form.

Advertising and Public Announcements

- 10.11 Advertisements and other invitations to invest in a scheme, including public announcements, shall be submitted for authorization prior to their issue or publication in Hong Kong. The general principle is that no advertisement can be made that is false, biased, misleading or deceptive. Any advertisement or announcement which concerns the trustee shall be accompanied by its written consent. Authorization may be varied or withdrawn by the Commission as it deems fit.
- 10.12 If a scheme is described as having been authorized by the Commission, it shall be stated that authorization does not imply official approval or recommendation.

Chapter 11: Termination or Merger of a REIT

- 11.1 The scheme may be wound up by the court, otherwise, termination of the scheme shall be subject to holders' approval by special resolution at an EGM. Where the proposal to terminate the scheme is recommended by the management company, connected persons to the scheme shall abstain from voting if they hold interests in the scheme or if they intend to hold interest in any of its underlying real estate.
- 11.2 A scheme may be merged with another scheme(s) authorized by the Commission under this Code. Such merger shall follow any procedures set out in the constitutive documents or governing law of both schemes, and shall be subject to holders' approval by special resolution at an EGM. Where the proposal to merge the schemes is recommended by any of the management company (companies) of the schemes involved, connected persons to the proposing scheme(s) shall abstain from voting if they hold interests in the scheme(s).
- 11.3 A circular shall be served on holders of all the relevant schemes 21 days before the day of the EGM. The circular shall at least contain information including:
- (i) the rationale for the termination of the scheme or merger of schemes;
 - (ii) the effective date of the termination or merger;
 - (iii) the steps to be undertaken in relation to the assets held by the scheme(s);
 - (iv) the procedures and timing for the distribution of the proceeds (in the case of termination) or issuance of new units (in the case of a merger) arising therefrom;
 - (v) a valuation report for each relevant scheme prepared in accordance with Chapter 6.7;
Note: The date of the valuation report shall be the same date as that of the circular.
 - (vi) the alternatives available to investors (including, if possible, a right to switch without charge into another authorized scheme);
 - (vii) the estimated costs of the termination or merger and who is expected to bear these costs; and
 - (viii) such other material information that the holders should be informed of.
- 11.4 A notice shall be sent to holders informing them of the result of the EGM.
- 11.5 Upon holders' approval of the termination of the scheme or merger of schemes, the scheme(s) shall cease to create, cancel, sell or redeem units. No transfer of the units may be registered and no other change to the register of holders may be made without the sanction of the trustee(s).
- 11.6 The terminating scheme shall cease to carry on its business, except so far as may be required for the benefit of winding up; however, the obligations of the trustee, the management company and the property valuer shall continue until the scheme is dissolved.

11.7 In the case of termination, the trustee shall, as soon as practicable after the scheme falls to be wound up, realize the properties of the scheme and, after paying thereout or retaining adequate provisions for liabilities properly so payable and retaining provision for the costs of the winding up, distribute the proceeds of that realization to the holders proportionately to their respective interests in the scheme at the date of the termination of the scheme.

Notes: (1) All real estate held by the scheme shall be disposed of through public auction and the open bid prices of the real estate shall reflect the prevailing available market prices for such real estate.

(2) The trustee shall ensure that the liquidation exercise is completed within six months from the date the termination takes effect.

(3) All cash proceeds derived from the liquidation of the scheme shall be distributed to holders on a pro rata basis within one month from the completion of the liquidation exercise.

(4) Distributions to holders upon termination of the scheme shall be made in cash only.

11.8 Subject to any order of the court, while a scheme is being wound up, the scheme shall continue to prepare its annual or semi-annual report, whichever is applicable.

11.9 On completion of the liquidation of the scheme or merger of schemes, an audited financial statement of the scheme shall be prepared as of the date of the scheme termination or merger. Copies of the report shall be distributed to unit holders within 21 days of the completion of the liquidation or merger and a copy shall be filed with the Commission. Such report shall at least:

- (a) state the net asset value of the scheme(s) as at the date of termination or merger and the relevant net asset value per unit;
- (b) explain how the winding up or merger has been conducted;
- (c) explain how the real estate has been disposed of, the transaction prices and major terms of disposal, in the case of termination, and how the real estate has been accounted for in the merged scheme, in the case of merger;
- (d) state the date on which the scheme's affairs were fully wound up or the schemes were fully merged, and the date stated must be regarded as the final day of the accounting period of the scheme(s); and
- (e) a statement by the auditor that the final account has been properly prepared for the purpose of the winding up or the merger.

11.10 All circulars and notices shall be submitted to the Commission for prior approval. They must, at least, contain all the information listed in this Chapter. The items listed are not meant to be exhaustive, the Commission may require additional information to be disclosed.

Chapter 12: Additional Requirements for Issue of New Units and unlisted REITs

Note: A scheme is not required to provide a redemption facility under this chapter once it is listed on the Hong Kong Stock Exchange.

Redemption of Units

12.1 The scheme shall provide for redemption at least once a year. The redemption period shall last for at least 21 calendar days after the offer is made.

Notes: (1) The scheme shall ensure that it offers not more than 10% of its outstanding units for redemption in each calendar year.

(2) A notice of any offer to redeem units shall be sent to holders at least 21 days before the commencement of the redemption period. Such notice shall provide information including:

(i) the price at which each unit will be redeemed and the basis for such price;

(ii) the period during which the offer will remain open; and

(iii) the number of units eligible for redemption.

(3) No redemption requests made pursuant to the offer may be satisfied until after the close of the offer period.

(4) If the redemption requests exceed the amount offered for redemption, the requests are to be satisfied proportionately in accordance with the formula:

$$\frac{\text{Number of units Available for redemption}}{\text{Number of units Available for redemption}} \times \frac{\text{Number of units a holder requests to redeem}}{\text{Total of units that holders request to redeem}}$$

12.2 The scheme's redemption price shall be published in at least one leading Hong Kong English language and one Chinese language daily newspaper, as soon as it is available.

Note: For the purpose of calculating the redemption price, the scheme shall adopt the valuations of the valuation report prepared on the same date as that of the circular prepared in respect of the redemption.

12.3 The maximum interval between the last date of the redemption period and the payment of the redemption money to the holder may not exceed one calendar month.

12.4 Any payment to holders upon redemption of units shall be made in cash.

12.5 Any change in the timing of the redemption period is subject to approval by holders by way of special resolution.

Issuance of New Units

12.6 An Extraordinary General Meeting shall be called and a special resolution shall be required.

Notes: (1) If the total number of units issued during the year is less than 20% of the number of outstanding units at the beginning of the financial year, then approval by holders is not required.

(2) Holders shall be given the right of first refusal.

(3) A circular shall be sent to holders 21 days prior to the EGM, stating information such as the purpose of the issue and the proposed use of the proceeds. The circular shall comply with Appendix D if it relates to a property transaction.

(4) For the purpose of calculating the issue price of an unlisted scheme, such scheme shall adopt the valuations of the valuation report prepared on the same date as that of the circular prepared in respect of the issue of units.

(5) A notice shall be sent to holders to inform them of the result of the EGM.

(6) New units can only be issued in exchange for cash.

Information to be Disclosed in the Offering Document

This list is not intended to be exhaustive. The management company is obliged to disclose any information which may be necessary for investors to make an informed judgement.

Constitution of the Scheme

A1 Name, registered address and place and date of creation of the scheme, with an indication of its duration if limited.

Investment Objectives and Restrictions

A2 The offering document of the scheme shall clearly include:

- (i) the investment policy and strategy of the management company;
- (ii) the scope and type of investments made or intended to be made by the scheme, including the type(s) of real estate (e.g. residential/commercial/ industrial);
- (iii) the location and the general character and competitive conditions of all real estate properties now held or intended to be acquired by the scheme;
- (iv) any proposed program for renovation or improvement to the properties, including the estimated costs thereof and the method of financing to be used;
- (v) the operating data of each of the properties, including the occupancy rate, number of tenants and its mix in terms of occupation or business, principal provisions of the leases, average annual rental per square foot, and schedule of lease expirations for the next five years;
- (vi) the borrowing policy and the method or proposed method of operating and financing the scheme's real estate investments;
- (vii) the investment risks of the scheme;
- (viii) the dividend policy;
- (ix) a statement with respect to any material policy regarding real estate activities; details of transactions or agreements entered into with connected parties;
- (x) full particulars of the nature and extent of the interest, if any, of any director of the trustee, the management company, the property valuer or any other connected persons to the scheme, in the property owned or proposed to be acquired by the scheme, where the interest of such a director consists in being a partner in a firm, the nature and extent of the interest of the firm, with a statement of all sums paid or agreed to be paid to him or the firm for services rendered to the scheme;

- (xi) a valuation report prepared by a property valuer in accordance with Chapter 6 with respect to all the scheme's interest in real estate, including particulars of each property owned by the scheme or contracted for purchase by the scheme;

Note: If the scheme has obtained more than one valuation report regarding any of its properties within six months before the issue of the offering document, then all other such reports shall be included.

- (xii) particulars of any bank overdrafts or similar indebtedness of the scheme, or if there is no such indebtedness, a statement to that effect;
- (xiii) the identities of the parties involved in the management, operation or valuation of the scheme and their responsibilities; and
- (xiv) identity of holders who hold or have subscribed to more than 10% of the scheme.

A3 If the nature of the investment policy so dictates, a warning that investment in the scheme is subject to abnormal risks, and a description of the risks involved.

Operators and Principals

A4 The names and registered addresses of the following parties (where applicable):-

- (a) the management company;
- (b) the trustee;
- (c) delegates of the management company;
- (d) the property valuer;
- (e) the auditor; and
- (f) the registrar.

Characteristics of Units

A5 Minimum investment and subsequent holding (if any).

A6 A description of the different types of units, including their currency of denomination.

A7 Form of certification.

A8 Frequency of valuation and dealing, including dealing days.

Application and Redemption Procedures

A9 Names of the Hong Kong daily newspapers in which prices will be published.

A10 Procedure for subscribing/redeeming units, and in the case of umbrella funds, conversion of units.

A11 The maximum interval between the request for redemption and the despatch of the redemption proceeds.

A12 Statement that no money shall be paid to any intermediary in Hong Kong who is not a dealer or exempt dealer.

Distribution Policy

A13 The approximate dates on which dividends will be paid.

Fees and Charges

- A14**
- (a) the level of all fees and charges payable by an investor (see 9.12 to 9.13), including all charges levied on subscription, redemption and conversion (in the case of umbrella funds);
 - (b) the level of all fees and charges payable by the scheme, including management fees, trustee fees and start-up expenses; and
 - (c) the notice period for fee increases (see 10.4).

Note: In the case of indeterminable fees and charges, the basis of calculation or the estimated ranges shall be disclosed.

Taxation

A15 Details of Hong Kong and principal taxes levied on the scheme's income and capital, including tax, if any, deducted on distribution to holders.

Reports and Accounts

A16 The date of the scheme's financial year.

A17 Particulars of what reports will be sent to registered holders and when (including those in 10.6). If there are bearer units in issue, information shall be given on where in Hong Kong reports can be obtained.

Warnings

A18 Statements/warnings shall be prominently displayed in the offering document as follows:-

- (a) "Important - if you are in any doubt about the contents of this offering document, you shall seek independent professional financial advice".
- (b) A statement to the effect that the rental yield on real estate held by the scheme is not equivalent to the yield on the units.

General Information

- A19** A list of constitutive documents and an address in Hong Kong where they can be inspected free of charge or purchased at a reasonable price.
- A20** The date of publication of the offering document.
- A21** A statement that the directors of the scheme or the management company accept responsibility for the information contained in the offering document as being accurate at the date of publication.
- A22** Details of unauthorized schemes shall not be shown in the offering document. Where names of such schemes are mentioned, these shall be clearly marked as unauthorized and not available to Hong Kong residents.
- A23** Details of listing procedures and special information relating to listing.

Termination of Scheme

- A24** A summary of the circumstances in which the scheme can be terminated.

Merger of Scheme

- A25** A summary of the circumstances in which the scheme can be merged with another scheme(s).

Contents of Financial Reports

The annual report shall contain, at a minimum, the following:

1. manager's comments and review on the performance of the scheme, and discussions on the strategy, plans and operations for the coming year;
2. summary of all real estate sales and purchases as well as connected party transaction(s) entered into during the relevant period;
3. valuation report as described in Chapter 6;
4. trustee's report as required under 4.2;
5. A report of the names of the top five real estate agents and contractors engaged by the scheme during the financial year, based on the value of commissions paid or the value of the service contracts. Such report shall include a breakdown of the consideration attributable to each of the agents or contractors by way of figures and percentages, and a description of the services/works contracted for.
6. A set of financial statements comprising:
 - (a) Balance Sheet;
 - (b) Income Statement;
 - (c) Cash Flow Statement;
 - (d) Distribution Statement
 - (e) Statement of Movements in Capital Account;
 - (f) Comparative figures for the statements referred to in (a) to (e) above inclusive for the corresponding previous period;
 - (g) Accounting Policies and Explanatory Notes;
 - (h) Auditor's report; and
 - (i) Performance table.

Note: Financial statements of a REIT are required to conform with either:

- (i) *Accounting standards approved by the Hong Kong Society of Accountants and laid down in the Statements of Standard Accounting Practice issued from time to time by that Society; or*
- (ii) *International Accounting Standards ("IAS") as promulgated from time to time by the International Accounting Standards Committee. Schemes which adopt IAS, are required:-*
 - *to disclose and explain differences of accounting practice between IAS and generally accepted accounting principles in Hong Kong, which have a significant effect on their financial statements; and*
 - *to compile a statement of the financial effect of any such material differences.*

The semi-annual report shall contain, at a minimum, the following:

1. manager's comments and review on the performance of the scheme, and discussions on the outlook for the coming half-year;
2. list of properties held by the scheme;
3. summary of real estate sales and purchase, as well as connected party transactions during the interim period;
4. Valuation certificate; and
5. performance table.

Balance Sheet

The Balance Sheet shall separately disclose, where applicable, at least the following items:

1. Total value of real estate
2. Cash and cash equivalents
3. Formation costs
4. Rentals and other receivables
5. Amounts receivable on subscription
6. Bank loans and overdrafts or other forms of borrowings
7. Amounts payable on redemption
8. Distributions payable
9. Total value of all assets
10. Total value of all liabilities
11. Revaluation reserve
12. Net asset value
13. Number of units in issue
14. Net asset value per unit

Income Statement

The Income Statement shall separately disclose, where applicable, at least the following items:

1. Gross rental income from real estate
2. Other income, broken down by category
3. Deficit on revaluation taken to the Income Statement during the accounting period
4. Profit or loss on disposal of any investment properties
5. Equalization on issue and cancellation of units
6. An itemized list of various expenditure charged to the scheme including:-
 - (a) fees paid to the management company;
 - (b) remuneration of the trustee;
 - (c) fees paid to property manager;
 - (d) fees paid to property valuer;
 - (e) other amounts paid to any connected persons of the scheme;
 - (f) amortization of formation costs;
 - (g) interest on borrowings;
 - (h) directors' fee and remuneration;
 - (i) safe custody and bank charges;
 - (j) auditors' remuneration;
 - (k) legal and other professional fees; and
 - (l) commission paid to property agents .
7. Taxes
8. Amounts transferred to and from the capital account
9. Net income for distribution

Cash Flow Statement

The Cash Flow Statement shall include:

1. Cashflows from operating activities;
2. Cashflows from investing activities; and
3. Cashflows from financing activities

Distribution Statement

The Distribution Statement shall separately disclose, where applicable, at least the following items:

1. Net after tax income for the period
2. Interim distribution per unit and date of distribution
3. Final distribution per unit and date of distribution

Statement of Movements in Capital Account

The Statement of Movements in Capital Account shall separately disclose, where applicable, at least the following items:

1. Value of the scheme as at the beginning of the period
2. Number of units issued and the amounts received upon such issuance (after equalization if applicable)
3. Number of units redeemed and the amount paid on redemption (after equalization if applicable)
4. Any items resulting in an increase/decrease in value of the scheme including:
 - (a) surplus/loss on sale of properties
 - (b) exchange gain/loss
 - (c) unrealized appreciation/diminution in value of properties
 - (d) net income for the period less distribution
5. Amounts transferred to and from the Income Statement
6. Value of the scheme as at the end of the period

Notes to the Accounts

The following matters shall be set out in the notes to the accounts:

1. Principal accounting policies
 - (a) in respect of real estate, the basis of valuation, the treatment of changes in their value and the treatment of any revaluation on their sale;
 - (b) the revenue recognition policy regarding rental income and other income;
 - (c) the basis of amortization of formation costs;
 - (d) taxation; and

- (e) any other accounting policy adopted to deal with items which are judged material or critical in determining the transactions and in stating the disposition of the scheme.

Any changes to the above accounting policies and their financial effects upon the accounts shall also be disclosed.

2. Transactions with Connected Persons

The following shall be disclosed:

- (a) a description of the nature of any transactions entered into during the period between the scheme and the management company, the property valuer of the scheme or any entity in which those parties or their connected persons have a material interest, and a statement confirming that these transactions have been entered into in the ordinary course of business and on normal commercial terms;
- (b) details of all transactions which are outside the ordinary course of business or not on normal commercial terms entered into during the period between the scheme and the management company, or any entity in which these parties or their connected persons have a material interest;
- (c) name of the management company, the director of such entities or any connected persons of such entities or director who is entitled to profits from transactions in units or from management of the scheme, and the amount of profits to which each of them becomes entitled;
- (d) where the scheme does not have any transactions with connected persons during the period, a nil statement to that effect; and
- (e) the basis of the fee charged for the management of the scheme and the name of the management company.

3. Borrowings

State whether the borrowings are secured or unsecured and the duration of the borrowings.

4. Commissions

Commission paid to top five real estate agents and value of service contracts of the top five contractors engaged by the scheme during the year.

5. Contingent liabilities and commitments

Details of any contingent liabilities and commitments of the scheme.

- 6. If the free negotiability of any asset is restricted by statutory or contractual requirements, this shall be stated.

Contents of the Auditors' Report

The report of the Auditor shall state:

1. Whether in the auditor's opinion, the accounts prepared for that period have been properly prepared in accordance with the relevant provisions of the Trust Deed and the Code;
2. Without prejudice to the foregoing, whether in the auditor's opinion, a true and fair view is given of the disposition of the scheme at the end of the period and of the transactions of the scheme for the period then ended;
3. If the auditor is of the opinion that proper books and records have not been kept by the scheme and/or the accounts prepared are not in agreement with the scheme's books and records, that fact; and
4. If the auditor has failed to obtain all the information and explanations which, to the best of his knowledge and belief, are necessary for the purposes of the audit, that fact.

Performance Table

A comparative table covering the last 5 financial years or since launch, whichever is later, and including, for each financial year:-

- (a) the total net asset value at the end of the financial year;
- (b) the net asset value per unit at the end of the financial year;
- (c) the highest and lowest net asset value per unit (for an unlisted REIT) or the highest premium or discount (for a listed REIT); and
- (d) the net yield per unit at the end of the financial year.

Note: A performance table prepared for a semi-annual report shall include (a) to (d) for the relevant interim period.

Contents of the Trust Deed

The Trust Deed of a scheme shall be submitted to the Commission for prior approval. It shall, at a minimum, contain all the information listed in this appendix. The items listed are not meant to be exhaustive, the Commission may require additional information to be disclosed in the Trust Deed.

1. Name of Scheme

2. Participating Parties

A statement to specify the participating parties such as the management company, the trustee and the property valuer.

3. The scheme is subject to and governed under the law of Hong Kong

4. (a) A statement that the deed is binding on each holder as if he had been a party to it and so to be bound by its provisions and authorizes and requires the trustee and the management company to do as required of them by the terms of the deed.

(b) A provision that a holder is not liable to make any further payment after he had paid the purchase price of his units and that no further liability can be imposed on him in respect of the units which he holds.

(c) A declaration that the assets of the scheme is held by the trustee on trust for the holders of the units *pari passu* according to the number of units held by each holder.

5. Trustee

(a) A statement to list the obligations of the trustee as set out in Chapter 4.

(b) A statement that the trustee shall retire in the manner as stipulated in Chapter 4.

6. Management Company

(a) A statement to list the obligations of the management company as set out in Chapter 5.

(b) A statement that the management company shall retire as set out in Chapter 5.

7. Property Valuer

(a) A statement to list the obligations of the property valuer as set out in Chapter 6.

(b) A statement that the property valuer shall retire as set out in Chapter 6.

8. Investment Limitations and Dividend Policy

- (a) A statement to list the restrictions on the investment of the scheme assets and the maximum borrowing limit of the scheme (see Chapter 7).
- (b) A statement to prescribe the income distribution policy/mechanism of the scheme and approximate date when income will be distributed.

9. Issue of Units

A statement to stipulate the method of determining the issue price (see 9.10 and 12.6).

10. Redemption of Units

- (a) A statement that the scheme shall provide redemption at least once a year if its units are not listed on the Hong Kong Exchange.
- (b) A statement to stipulate the method of determining the redemption price (see 12.1).
- (c) A statement that the maximum interval between the last date of the redemption period and the payment of the redemption money to the holder may not exceed one calendar month.

11. Fees & Charges

The following shall be stated:-

- (a) the maximum percentage of the initial charge payable to the management company out of the issue price of an unit;
- (b) the maximum fee payable to the management company out of the assets of the scheme, expressed as an annual percentage;
- (c) fee payable to trustee;
- (d) fee payable to property valuer;
- (e) preliminary expenses to be amortized against the assets of the scheme; and
- (f) all other material fees and charges payable out of the property of the scheme.

12. Meetings

Provisions on the manner in which meetings are conducted in accordance with 9.11.

13. Transactions with Connected Persons

Information as stated in Chapter 8.

14. Annual Accounting Period

Calendar year date on which the annual accounting period of the scheme ends.

15. Base Currency

A statement of the base currency of the scheme.

16. Modification of the Trust Deed

A statement of the means by which modifications to the trust deed can be effected.

17. Termination of Scheme

(a) A statement of the circumstances in which the scheme can be terminated.

(b) A statement to list the procedures that are to be followed upon termination of the scheme (see Chapter 11).

18. Merger of Scheme

A statement to list the procedures that are to be followed upon the merger with another scheme(s) (see Chapter 11).

Contents of Circular to Holders

1. The following guidance points shall be borne in mind in preparing circulars that are required by the Code:
 - (a) the primary objective of the circular is to enable holders to properly and in an informed manner examine the reasonableness and fairness of the proposed transaction. The balance of advantage or disadvantage to the issuer must therefore be readily apparent to enable an unit-holder to reach his own conclusions on the proposal;
 - (b) the circular shall provide sufficient information to investors to evaluate the proposal; and
 - (c) where applicable, provide a fair and objective valuation on the assets of the scheme.

2. The scheme shall issue a circular to holders for the purpose of an EGM when it proposes to enter into:
 - (i) a transaction with a connected person as stated in Chapter 8 or;
 - (ii) the issue of new units as provided in 12.6; or
 - (iii) restructuring, amalgamation or mergers of the scheme or any of its underlying assets.

Note: The circular shall be sent to holders at least 21 days before the EGM is held.

3. The scheme shall issue a circular to holders within 21 days after it has entered into a property transaction which does not fall within Chapter 8.

Note: If the value of such transaction is below 15% of the gross asset value of the scheme, this requirement may be dispensed with and substituted by disclosure in the semi-annual or annual report, where appropriate, of the nature of the transaction and the relevant information.

4. The circular shall be submitted to the Commission for prior approval. It shall, at least, contain all the information listed in this appendix. The items listed are not meant to be exhaustive, the Commission may require additional information to be disclosed.

- (a) Prominent warning statement:

“THIS DOCUMENT IS IMPORTANT AND REQUIRES YOUR IMMEDIATE ATTENTION. IF IN DOUBT, PLEASE SEEK PROFESSIONAL ADVICE.”

(b) Responsibility statement:

“The management company directors jointly and severally accept full responsibility for the accuracy and completeness of the information contained in this document and confirm, having made all reasonable enquiries, that to the best of their knowledge and belief there are no other facts the omission of which would make any statement herein inaccurate or misleading.”

- (c) the date of the transaction and the parties thereto;
- (d) a general description of the nature of the asset concerned (if any);
- (e) the total consideration and the terms and composition thereof;
- (f) the financing arrangement and justification for such arrangement;
- (g) where applicable, the name of the connected person concerned and of the relevant associate (if any);
- (h) where applicable, the nature and extent of the interest of the connected person in the transaction;
- (i) an independent valuation in respect of the asset concerned (if any) prepared in accordance with Chapter 6;
- (j) a statement by the management company of any material adverse change in the financial or trading position of the scheme since the date to which its latest published audited accounts of have been made up, or an appropriate negative statement;
- (k) where appropriate, a statement that the connected persons will not vote in the extraordinary general meeting; and
- (l) an opinion, in the form of a separate letter, by the trustee or the management company (insofar as it is not conflicted out by virtue of its interest in the transaction) acceptable to the Commission as to whether the transaction is fair and reasonable so far as the holders of the scheme are concerned and such opinion shall set out the reasons for, the key assumptions made and the factors taken into consideration in, forming that opinion.

List of Questions

- Q1. Do you think that the eligibility requirements for the management company of REITs are sufficient? If not, why not and what other practical issues do you think we need to consider?*
- Q2. Do you think that the qualification requirements for the key personnel in the property management company of a REIT are sufficient? If not, why not?*
- Q3. To what extent do you think the management company shall delegate its property management function to a third party? Do you foresee any ambiguity arising from such segregation of duties? If so, how should this lack of clarity be dealt with?*
- Q4. What are your concerns if the management company manages a number of REITs which have similar investment objectives? How do you think such concerns should be addressed and why?*
- Q5. What are your concerns if the management company is related to the major shareholder of the REIT it manages? How do you think such concerns should be addressed and why?*
- Q6. Do you think that the eligibility requirements for the trustee of a REIT are sufficient? If not, why not and what are the other practical issues that we need to consider?*
- Q7. Do you think the Code should stipulate minimum requirements for the insurance policies of the properties held by a REIT? Do you think the trustee should be responsible for ensuring compliance with insurance coverage? If not, who should take responsibility?*
- Q8. Do you agree with the proposed eligibility requirements for the valuer of a REIT? If not, why not?*
- Q9. Given that the REIT concept is new to the Hong Kong market, the SFC intends to initially restrict the investment scope to real estate in Hong Kong, subject to future review. Do you think that this restriction will dampen the development of REITs in Hong Kong at this stage and if so, why?*
- Q10. If the Code is to include other geographical locations for investments by REITs, what criteria do you think such locations shall be required to meet in order that investors' interests are safeguarded, and why? Should there be any maximum exposure to non-Hong Kong real estate should a REIT be allowed to invest outside of Hong Kong, and why?*

- Q11. Should there be a requirement on a minimum initial fund size for a REIT to be viable, given the capital outlay for real estate properties can be substantial? If so, what would be an appropriate minimum fund size requirement in this case, and why?*
- Q12. Do you agree that the various proposed investment restrictions, namely, dividend pay-out policy, borrowing restriction, maximum cash holding level and the policy on returning excess cash are appropriate in the context of the Hong Kong market? If not, why not?*
- Q13. Currently, the Commission has not imposed any diversification requirements on REITs. Do you foresee that there will be any significant risks resulting from the lack of diversification in a REIT's portfolio? If so, what kind of risks?*
- Q14. It has been suggested that even in the absence of favourable tax treatment, REITs in Hong Kong should be competitive vis-à-vis their counterparts in overseas jurisdictions, given the simple tax system and the low rates of taxes in Hong Kong. Do you agree? Otherwise, what are your reasons for advocating preferential tax treatment?*
- Q15. Should the management company of a REIT be allowed to invest its own capital in the scheme? If it does, do you foresee any conflicts of interests and how should these conflicts be dealt with?*
- Q16. Currently, the definition of connected persons to the scheme does not include the scheme's major unitholders and their associates. In the event of a major transaction involving a major unitholder or its associates, do you think that such a transaction should be submitted for prior approval by the unitholders, with the counterparties to the scheme abstaining from voting? If not, why not?*
- Q17. Do you agree with the proposed frequency for the valuation of listed and unlisted REITs? If not, why not?*
- Q18. Do you agree with the liquidation period proposed in the Code upon the termination of a scheme? If not, why not? In your view, what would be an appropriate timeframe for liquidation and why?*
- Q19. What are other potential corporate governance or conflicts of interest issues that have not been addressed by the proposed Code? What are your proposals to address such issues?*
- Q20. Do you believe that having listing status on the Hong Kong Stock Exchange is an important factor in deciding on the viability of a REIT in Hong Kong? If so, why?*
- Q21. In your view, what are some of the obstacles for listing a REIT on the Hong Kong Stock Exchange?*

- Q22.** *Do you believe allowing a non-listed REIT to have an annual redemption facility of up to 10% of the outstanding units of the REIT is fair and practicable?*
- Q23.** *Apart from listing and creation of redemption / subscription facility, do you think it is desirable to allow for fixed term closed-end REITs as well? If so, why? Are there any other exit alternatives that the Commission should consider?*
- Q24.** *Do you think the proposed disclosure and reporting requirements for REITs are sufficient? What other additional disclosures should be required?*
- Q25.** *What risk warning statements shall be made in:*
- (a) Offering documents?*
 - (b) Regular reports?*
 - (c) Advertisements and marketing materials?*
- Q26.** *If a guarantee is provided, whether on dividends or capital, what kind of requirements do you think should be imposed, e.g. pledging of assets to the guarantor, amount of guarantee, qualifications of guarantor?*

Overseas Development of REITs

United States

The concept of REITs was first conceived by the US Congress when it passed the Real Estate Investment Trust Act in 1960. The intention of the legislation was to provide small investors with the opportunity to invest in large-scale income-generating real estate.

The Tax Reform Act in 1986 was important for the development of REITs in the US in two ways. First, it reduced the potential for real estate investments to become tax shelters. Second, it allowed REITs to own, operate and manage their property investments. However, even with such changes, the REITs market did not flourish immediately.

From 1990 to 1993, due to a combination of economic downturn and the Savings and Loan Crisis¹, US property market prices dropped by 30% - 50%. During that period, sources of financing, either in the form of credits or fund raising from the capital markets, were limited and scarce. At that point, the market turned to REITs as one of the most viable and efficient ways to access capital for property investment.

In the period of 1990 to 2002, the total market capitalisation of REITs expanded from US\$13 billion to approximately US\$162 billion, comprising 176 REITs listed on the New York Stock Exchange, American Stock Exchange or the NASDAQ National Market System. Roughly 82% of them are equity REITs.

Australia

The first initial public offering of LPT was made in 1971 on the Australian Stock Exchange. As in the case of the US, the LPT market did not develop in any meaningful way until the economic downturn in the nineties. In the seventies, i.e., the early phase of REITs development, the majority of Australian LPTs were unlisted.

From 1988 to 1990, property prices fell by more than 30% in Australia. The property downturn and economic recession created a confidence crisis that eventually led to a panic redemption of the unlisted LPTs. The experience of liquidity crunch faced by such unlisted LPTs led to the general adoption of listing by LPTs to allow investors exit from the LPTs without impacting on the actual cashflow of the LPTs. By the end of 2002, Australia had 40 listed LPTs, with a market capitalization of A\$51 billion, or US\$28 billion, compared with less than A\$5 billion in early 1990s.

¹ The downturn in the US real estate market in late 1980s had led to the collapse of hundreds of savings and loans institutions. These institutions lost billions of US dollars in the crisis due to their real estate exposure. This is commonly known as the Savings and Loan Crisis.

In addition to listing, the growth of LPTs in Australia was further facilitated by the introduction of the compulsory superannuation scheme² in 1992 which included LPTs as an eligible investment.

Japan

In Japan, REITs represent a relatively new investment vehicle. Japan's REIT-enabling legislation was passed in November 2000. REITs were introduced in Japan almost ten years after the collapse of the Japanese real estate market in early 1990s. The portfolios of the first two "J-REITs" issued by two major Japanese developers consisted of prime office properties in Tokyo and were subsequently listed on the Tokyo Stock Exchange in September 2001.

Initially, market reception of these two REITs was muted and share price performance was lethargic³.

There are a number of possible reasons why the J-REITs were not as successful as expected when they were first introduced, namely there were:

- concerns that interest rates in Japan would rise on the back of the depreciating Yen in the early part of 2002;
- market perception that property prices and rent would continue to adjust downward;
- perception of insufficient disclosure by J-REITs particularly on details of tenancy agreements and roll-over contract terms; and
- concerns regarding conflicts of interest arising from the fact that the holding companies of the two major issuers of the J-REITs were also heavily involved in property development business.

Therefore, investors initially perceived that J-REITs might have some structural problems. At the end of 2002, there were five listed J-REITs in Japan with a total market capitalisation of US\$ 4.2 billion.

Singapore

Regulatory guidelines for REITs in Singapore were released by the Singapore government in May 1999. In November 2001, an attempt was made to launch the first "S-REIT" with a portfolio of shopping malls via an initial public offering. However, the initial public offering received a lukewarm market response. Possible reasons for this include:-

- market perception that the valuation of the assets might be somewhat overvalued, hence, offered less than desirable yields;
- cautious investor sentiment at that time due to the September 11 terrorist attack;

² Effective since July 1992, the Australian Federal Government has required employers to contribute a fixed percentage (initially 3%, now 9%) of pay to superannuation plans (pension schemes) for every employee. This is known as superannuation guarantee charge.

³ As of early February 2002, prices of the first two J-REITs, Office Building Fund of Japan and Japan Real Estate Investment Corp, fell by a respective 23% and 10% since their initial listing.

- uncertainty over the experience of the property managers involved; and
- relatively limited knowledge of the REIT concept among retail investors.

By July 2002, the S-REIT was re-launched at a lower offer price and a higher yield. The response was good, and in late 2002, the second S-REIT was listed on the Singapore Stock Exchange. The initial public offering attracted a five-time over-subscription and US\$136 million worth of shares was sold. The improved market sentiment was reflected by the successful debut of the second S-REIT on its first day of trading. At the end of 2002, the total market capitalization of the two listed REITs in Singapore rose to US\$710 million.

Korea

The Korean REIT (K-REIT) was introduced with the enactment of the Real Estate Investment Company Act in July 2001. The primary form of REITs was Corporate Restructuring REIT (CR-REIT) which is registered in company form and can only operate for up to a maximum of five years. The principal function of a CR-REIT is to acquire real estate assets from troubled financial institutions at bargain prices and sell them at premiums. A CR-REIT usually has the following characteristics:

- no operational staff;
- its management is outsourced to asset management companies specializing in corporate restructuring; and
- is exempt from corporate tax as it virtually distributes all of its profits to investors in the form of dividends.

Two CR-REITs were established and subsequently listed on the Korea Stock Exchange in 2002. Initially, both of them received lukewarm responses to during their IPO launches, possibly due to concerns over poor corporate governance. Uncertainty over the possibility of competing disposal of assets by the two CR-REITs dampened investors' expectations of capital appreciation at the time.

There were three listed REITs in Korea as at 2002-end⁴:

	IPO Date	Market Cap (US\$' m)	Indicated Dividend Yield
Kyobo-Meritz First CR-REIT	30 Jan 02	70.6	3.99%
KOCREF CR-REIT 1	30 May 02	113.6	N/A
KOCREF CR-REIT 2	11 Nov 02	48.4	N/A

⁴ Data from Bloomberg