



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

# Consultation Paper on Draft Practice Note on Overseas Investments by SFC-Authorised Real Estate Investment Trusts

Hong Kong  
March 2005

**CONSULTATION PAPER ON  
DRAFT PRACTICE NOTE ON OVERSEAS INVESTMENTS BY  
SFC-AUTHORISED REAL ESTATE INVESTMENT TRUSTS**

The Securities and Futures Commission (“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 30 April 2005**. Any person wishing to submit comments on behalf of any organization should provide details of the organization whose views they represent.

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

**You may not wish your name to be published by the Commission. If this is the case, please state that you wish your name 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  
8/F Chater House  
8 Connaught Road Central  
Hong Kong

By fax to: (852) 2877 0318

By on-line submission: <http://www.sfc.hk>  
(Please enter into the subsection “Consultation papers and Conclusions” under the section “Speeches & Publications” on the website <http://www.sfc.hk>)

By e-mail to: [reits@sfc.hk](mailto:reits@sfc.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 Commission. A copy of this paper can also be found on the Commission website at <http://www.sfc.hk>.

Investment Products Department  
Securities and Futures Commission  
Hong Kong  
March 2005

## **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 Data<sup>1</sup> will be used following collection, what you are agreeing to with respect to the Commission’s use of your Personal Data and your rights under the Personal Data (Privacy) Ordinance (Cap. 486) (“PDPO”).

### *Purpose of Collection*

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

### *Transfer of Personal Data*

3. Personal Data may be disclosed by the Commission 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 Commission website and in documents to be published by the Commission 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 Commission has the right to charge a reasonable fee for processing any data access request.

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

<sup>2</sup> Defined in Schedule 1 to the Securities and Futures Ordinance (Cap. 571) (“SFO”) to mean provisions of the SFO and subsidiary legislation made under it; and provisions of Parts II and XII of the Companies Ordinance (Cap. 32) insofar as those Parts relate, directly or indirectly, to the performance of functions relating to prospectuses; the purchase by a corporation of its own shares or a corporation giving financial assistance for the acquisition of its own shares, etc.

*Retention*

5. Personal Data provided to the Commission in response to the Consultation Paper will be retained for such period as may be necessary for the proper performance of the Commission's functions.

*Enquiries*

6. 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:

The Data Privacy Officer  
The Securities and Futures Commission  
8/F Chater House  
8 Connaught Road Central  
Hong Kong

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

# **CONSULTATION PAPER ON DRAFT PRACTICE NOTE ON OVERSEAS INVESTMENTS BY SFC-AUTHORISED REAL ESTATE INVESTMENT TRUSTS**

## **INTRODUCTION**

The Securities and Futures Commission (“Commission”) invites comments from the public on the proposed benchmarks for regulating investments in overseas properties by real estate investment trusts (“REITs”) authorised by the Commission under the Code on REITs.

The aim of this consultation paper is to solicit market feedback on the proposed requirements that SFC-authorized REITs have to comply with when investing in overseas properties in order to ensure that such REITs afford the same standards of investor protection and disclosure of information as those that only invest in Hong Kong properties. 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 proposals are finalized and adopted as a practice note to the Code on REITs.

## **EXECUTIVE SUMMARY**

When the Commission adopted the Code on REITs (the “Code”) in July 2003, it restricted investments to properties in Hong Kong. The Commission is cognizant of the desirability of allowing REITs the flexibility of investing in overseas properties, as that would give investors a wider investment choice and an opportunity to diversify their investments.

Following the release of the Code, the Commission set up the Taskforce on Overseas Real Estate Investments by REITs (the “Taskforce”) in October 2003 to examine the minimum benchmarks that REITs should meet when they invest in overseas properties. Having considered the recommendations from the Taskforce and discussed with the industry on the future development of Hong Kong’s REITs market, the Commission believes that it is the appropriate time to lift the restrictions on overseas investments for REITs.

The Commission understands that the market characteristics, investment considerations and risk factors involved in overseas investments may be different from those encountered in Hong Kong in many respects, due to the unique characteristics of overseas jurisdictions and their different rules and regulations. The Commission now proposes a draft Practice Note to provide concrete guidance as to how to apply the regulatory principles in the Code. In formulating the draft Practice Note, the Commission believes that the following basic principles should be upheld:

- (a) all REITs, whether they invest in Hong Kong or overseas properties, should be regulated by the same regime, ie., the Code on REITs. There should not be separate sets of rules for different jurisdictions;
- (b) the management company has full responsibility for the management of a REIT. It must have the requisite competence, experience, resources and appropriate risk

control systems. It is also required to conduct all proper due diligence taking into consideration the risks and characteristics of the relevant overseas jurisdiction(s) and the properties intended for acquisition by the REIT;

(c) each operator of a REIT, including its management company, valuer, listing agent, trustee and auditor, has its own duties and responsibilities with respect to the REIT and its investors, and is expected to discharge these responsibilities properly, professionally and with all due care; and

(d) clear, proper and timely disclosures must be made at all relevant times.

The full set of the draft Practice Note is attached in **Appendix 1**. While the draft Practice Note is designed to assist management companies intending to invest in overseas markets, the draft Practice Note also serves to provide more specific guidance on the application of certain broad principles in the Code. As such, the draft Practice Note is applicable to all REITs, where appropriate, and not just those that invest in overseas properties.

In the soft consultation with market practitioners, the Commission has been advised on the need to revisit the gearing limit as currently stipulated in the Code. The Commission also wishes to consult the market on whether the current ratio of 35% should be revised and if so, the appropriate limit. The market is also invited to express views on any other special product features that the Commission should consider in product applications.

As stated in the conclusion of the consultation on the Code in 2003, an SFC-authorized REIT effectively operates like a listed company. In addition, its management company is subject to the on-going monitoring of the Commission. The amount of resources required in processing a REIT application and conducting an on-going supervision is no different from those involved in dealing with listed vehicles. Therefore, the Commission proposes to review the fees applicable to a REIT application so that the fees could be set on a cost recovery basis. At present, the Commission is charging applications for authorisation of REITs on a flat fee basis of HK\$20,000 whereas listed property vehicles application fees are generally based on the size of market capitalisation of the vehicles.

Finally, the Commission would like to thank all members of the Taskforce for their advice and contribution to the study on regulating overseas investments by REITs within the last eighteen months.

## **PROPOSALS FOR REGULATING OVERSEAS INVESTMENTS BY REITS**

### ***Background***

In assessing the relevant regulatory and market issues relating to REITs, the Commission established the Taskforce in October 2003 to examine the risks involved in overseas property investments, based on their experience and case studies. The Taskforce comprises of representatives from the legal profession, property investment and management, corporate finance, accountancy, property valuation and trustee business. The membership list of the Taskforce is shown in **Appendix 2**.

## *Management Company*

### Qualifications Requirements

When investing in and managing overseas properties, certain risks can be mitigated if a management company has proper measures in place. On this basis, at a minimum, a management company that proposes to invest overseas must be able to demonstrate that it has the requisite competence, experience and resources to analyse the issues and risks involved in overseas investment, to develop, implement and keep up-to-date a set of effective internal controls and risk management system to deal with existing and foreseeable risks involved in overseas investments, and to inform investors in a clear, concise and timely manner of the investment profile and risks of a REIT. There should also be a detailed business plan in support of such overseas activities.

In addition to establishing the proper risk management and internal controls system, the management company may take out professional insurance indemnity insurance as an additional safeguard to deal with the operational risks in relation to the management of a REIT. Of course, such arrangement may increase the operating costs to the management company and it should balance the costs and benefits prior to entering into any such arrangement.

The degree of complexity that a management company has to deal with when investing in and managing overseas properties depends on the jurisdiction(s) where the properties are located. As a general rule, as the number of property increases, especially where properties are situated in different jurisdictions, the demand on the resources, expertise and internal control system of the management company multiplies.

Therefore, in licensing a management company as a REIT manager that invests in overseas properties, the Commission will generally only allow it to manage one REIT and will impose such conditions as may be appropriate in the light of the unique circumstances of the management company.

Licensing conditions may be reviewed and varied as and when the management company establishes its track record and can demonstrate to the Commission that it has the expertise and capability to go beyond its existing restrictions. In exceptional cases where the management company can demonstrate that it has extensive operational support, adequate key personnel with cross-jurisdictional property investment experience and management expertise, strong financial and organizational backing and an established track record of property portfolio management for the retail public, the Commission may consider granting a licence to manage more than one REIT at the outset.

As a gatekeeper, the Commission believes that this proposed approach is important to the development of a healthy REIT market in Hong Kong that enjoys the confidence of investors. In fact, this practice is also adopted in Australia where generally a new entrant will only be authorised under its licence to only manage one named scheme until it can establish a track record. The Commission has also sought views from the Taskforce and market practitioners as to the practicality of such approach and the overall response is that this is the right approach.

## Due diligence

In respect of property investments, the management company must perform sufficient and proper due diligence on the subject property to ensure that the ownership of the subject property by a REIT is properly and legally established, the relevant contracts and agreements are legally valid and binding, and the interest of the REIT holders is adequately protected. Since one of the most important requirements in the Code is that a REIT has legal and beneficial title to all the properties that it owns, due diligence process should be conducted with regard to the risks and practices of the relevant jurisdiction. The details of the process should be properly documented. Where practicable and justified, the management company may also take out title insurance in respect of the overseas properties to ensure that a REIT has legal and beneficial ownership of its properties, regardless of the unique circumstances of the relevant property.

While the draft Practice Note sets out certain areas to which the management company must pay attention in its due diligence process on overseas investments, the Practice Note is neither a substitute for the detailed process and the areas or aspects into which due diligence must be undertaken, nor for the duty on the part of the management company to make the qualitative assessment as to the nature, extent, scope and depth of the due diligence necessary and appropriate. Due diligence exercise is an interactive and dynamic process depending on the specific cases and it is incumbent on the parties carrying out the due diligence to ensure all relevant aspects of an overseas investment are considered and examined to their reasonable satisfaction.

The management company may engage overseas experts to conduct due diligence, but it must ensure that such experts are qualified and have the experience in conducting due diligence on the type of properties in the relevant jurisdiction. Such appointment of overseas experts does not absolve the management company from its duties and responsibilities, and its obligations to conduct proper and adequate due diligence.

The management company may also engage overseas experts / delegates or enter into joint arrangement with overseas partners for on-going management of properties. In this regard, the management company must conduct thorough due diligence on its delegates or partners to ensure that the principles and standards espoused in the Code and the draft Practice Note are not undermined as a result of such delegation or partnership.

## Continuous supervision

The management company should establish policies and procedures to monitor the activities of its delegates and partners on an on-going basis. There should also be regular reviews as to whether such delegation and joint arrangement remains to be in the interest of the REIT holders, and whether the delegates or partners are still suitable.

## Disclosure

Since the characteristics and risks of overseas investments are different from those of Hong Kong, and the general public may not be familiar with such features, the

management company should clearly and accurately disclose the operational hurdles and risks of overseas investments for investors' knowledge. The disclosures have to be specific to the types of properties that a REIT invests in and the business models that the management company adopts. The management company should not use disclosures to disclaim liability.

### ***Trustee***

Aside from assuming the role of safekeeping the assets of a REIT, the trustee of a REIT should, in discharge of an oversight function, ensure that the management company acts in the best interests of the REIT holders and in accordance with the constitutive documents of the REIT and the relevant regulatory and legal requirements of the subject overseas jurisdiction. The trustee should make all reasonable endeavours to verify the legality and authenticity of all contracts and agreements in relation to a REIT, including title deeds and tenancy contracts.

### ***Listing agent and financial adviser***

The role and responsibilities of the listing agent and the financial adviser are no different from those of a sponsor of an initial public offering and the corporate finance adviser to a listed company in relation to a transaction. Therefore, when conducting due diligence work, they are required to act in an independent manner, demonstrating such standards of due diligence comparable to those of their counterparts.

### ***Valuer***

The valuer appointed by a REIT (the "Principal Valuer") must be qualified in Hong Kong to act as a valuer and is ultimately responsible for the valuation of all the properties owned by a REIT, regardless of their locations. The Commission understands from the Taskforce that in certain jurisdictions where the Principal Valuer has neither a business presence nor the relevant expertise, the Principal Valuer may have to appoint an overseas valuer to conduct valuation of properties in such jurisdictions. However, there may be a vast disparity in standards among different overseas valuers in certain jurisdictions. Therefore, while the Commission allows the appointment of overseas valuers, the Principal Valuer must conduct thorough due diligence prior to the engagement of any overseas valuer, and must ensure that such valuer possesses experience and qualifications commensurate with those required of a valuer under the Code on REITs.

### ***Auditor***

On the accounting front, in order to provide investors with a better understanding and greater comparability of the financial statements of REITs, it is important that REITs adopt the same accounting principles regardless of whether they invest locally or overseas. Accordingly, financial statements of all REITs have to be prepared in accordance with Hong Kong Generally Accepted Accounting Principles or International Financial Reporting Standards. Once adopted, the standards have to be consistently applied to facilitate understanding and year-on-year comparison.

## *Gearing*

During the soft consultation, market practitioners suggested a review of the existing limit of 35% on gearing. It was pointed out that since overseas investments involved currency risk, REIT managers of overseas properties would generally finance a higher percentage of overseas property investments by borrowing foreign currency. The use of higher gearing would serve various purposes:

- (a) there would be a better matching of assets and liabilities on the one hand, and of income and expenses on the other hand, in terms of currency exposure;
- (b) the capital commitment to overseas investments would be reduced and the exposure to overseas currency risk upon conversion of sales proceeds would be minimised; and
- (c) the higher interest expenses would help offset the revenue derived from the overseas properties, thereby reducing the tax liability in the overseas jurisdictions.

In Australia, where some REITs have started to invest in overseas properties, such as those in the US, overseas investments were generally geared between 35% to around 50% in order to align with the financing structure of the REITs in the US.

Notwithstanding the advantages of higher gearing, it should be noted that these benefits are not without risks. The more leveraged a REIT, the more susceptible it is to interest rate risks, market downturn and economic changes. The ability of a REIT to service its debts would impact its credit standing which would eventually affect its valuation and cost of capital.

Of course, in the event that it is decided to relax the gearing ratio, the relaxation would apply equally to REITs that invest in local properties.

## **PROPOSALS FOR COMPETENCE REQUIREMENTS OF REIT MANAGERS**

In February 2005, the Commission issued a consultation paper proposing certain amendments to Part 2 of Schedule 5 to the Securities and Futures Ordinance (“SFO”) which sets out the definitions of different types of regulated activity and impacts on the licensing and registration matters under Part V of the SFO. One of the proposed amendments is to clarify the SFO by stating clearly that managers of SFC-authorized REITs are asset managers (regulated activity Type 9) and must be licensed by the Commission. In licensing the REIT managers, the Commission will directly recognise property portfolio management experience as being a core competency.

The Commission is prepared to directly accept a property portfolio manager as a REIT manager provided that it also possesses in-house relevant investment management expertise. This should allow well-established property portfolio managers in Hong Kong or in the region to apply for a REIT manager licence on their own, participate in the development of the REIT market in Hong Kong and transfer their expertise to this new area of investment management.

Of course, as Commission licensees, such property portfolio managers must also demonstrate that they are fit and proper and satisfy all relevant criteria for obtaining a licence, including having passed an examination or satisfied alternative requirements.

Given that the REIT manager licence is still a new category of licence, the Commission has already set up a dedicated team to answer queries from market practitioners. Management companies are welcome to seek guidance from the Commission to facilitate their resources and business planning.

## **COMMENTS FROM THE PUBLIC**

The Commission seeks the public's comments on the above proposals regarding regulation of overseas investment by SFC-authorized REITs. In addition to comments on the overall proposal, the Commission also seeks comments on the following specific issues:

- (1) Based on the experience of REITs in other jurisdictions, do you think that the limit on gearing ratio should be raised to 40%-50%, from the current 35% stated in the Code?
- (2) Market practitioners have suggested that the Commission should consider allowing special product features, such as payment of management fees by way of issuance of units. These were made based on observations of the recent development in other major REITs markets. The Commission is prepared to consider, on a case-by-case basis, requests for incorporation of special features in a REIT subject to the overall principle that investor interest can be safeguarded. In this connection, what particular features do you think the Commission should consider in product applications?
- (3) Should the REIT application fee be levied on a cost recovery basis?
- (4) Do you have any views on whether the management company could/should take out professional indemnity insurance and title insurance?

Please submit your comments in writing no later than 30 April 2005.

## **PREPARATION FOR THE ADOPTION OF THE DRAFT PRACTICE NOTE**

The Commission has been approached by various market practitioners and promoters about their plans to launch REITs that invest in overseas properties. In fact, to facilitate their preparation, the Commission is ready to simultaneously discuss with interested parties the practical application of the draft Practice Note and the licensing of REIT managers. The Commission is prepared to address these issues pragmatically.

## **WAY FORWARD**

A final set of Practice Note will be published upon consideration of the comments received in the consultation. Where appropriate, consequential amendments will be made to the relevant rules in the Code.

## **Draft Practice Note on Overseas Investments by SFC-authorized REITs**

### **Introduction**

1. With effect from [ ], the Code on REITs (the “Code”) has been amended to allow SFC-authorized REITs to invest in overseas properties in accordance with the provisions of the Code. It is generally accepted that the market characteristics, investment considerations, and types and level of risks faced by a REIT when investing in and managing overseas properties may be different from those faced by a REIT that invests in Hong Kong properties. These differences may arise in areas such as legal and accounting systems, regulatory framework for properties, valuation methodology, and political and economic environment.
2. The management company is expected to have the requisite competence, experience, and effective internal controls and risk management system for conducting property investments and management in the relevant overseas jurisdiction. It is also required to comply with applicable laws and regulations governing its conduct as an intermediary in investment management business. Decisions to invest in overseas properties shall be made solely in the best interests of holders. A management company’s responsibility and duty towards holders shall not be diminished or undermined when a REIT invests in overseas properties. While a management company may delegate functions, it cannot delegate or absolve itself from its responsibilities and duties in relation to the management of a REIT.
3. The Code has set out the general principles and requirements to be followed by the parties involved in the operation of a REIT including the management company, trustee, valuer and auditor (collectively, the “REIT operators”). Such general principles and requirements shall equally apply in the case of a REIT investing in overseas properties. However, with a potentially different operating environment for a REIT investing in overseas properties, the Commission is mindful of the need to reiterate and, where necessary, to elaborate on the practical application of the Code provisions to REITs that own and manage overseas properties.
4. REIT operators shall possess relevant expertise and implement effective risk control system when carrying out their respective functions in connection with a REIT that invests in overseas properties. However, it is also recognized that certain overseas investment risks, though capable of being minimised, cannot be completely eliminated.
5. This Practice Note aims to highlight to REIT operators that they are responsible for applying appropriate measures and safeguards to mitigate foreign investment risks as much as practicable and to clearly, reasonably and accurately disclose the risks involved in investing overseas to investors so as to enable them to make informed investment decisions.

6. This Practice Note forms part of the Code and is to be read in conjunction with the Code for an overall view of the regulatory framework for REITs that invest in overseas properties.
7. This Practice Note also supplements the disclosure requirements set out in the Code. Applicants are reminded to refer to the Code which, among other things, also identifies circumstances where specific disclosure is required and the manner in which such disclosure has to be made.
8. Unless otherwise stated, words and expressions defined in the Code shall bear the same meaning in this Practice Note.

### **Safeguarding measures for overseas investments**

#### Qualifications of the management company

9. The complexity and risks involved in making property investments and divestment vary from country to country, as each jurisdiction has its own unique legal framework, legislative requirements, business operations model and stage of economic development. In determining whether a REIT shall invest in overseas properties, the management company shall assess the suitability of such decision with reference to its experience, capability, resources and competence, and its track record in dealing with the legal, regulatory and other requirements of overseas property investments. Where applicable, there shall be firm support from the group of which the management company is a member. The management company shall also demonstrate such suitability to the Commission.
10. When investing in and managing overseas properties, certain risks can be mitigated if a management company has proper measures in place. On this basis, at a minimum, a management company that proposes to invest overseas must be able to demonstrate that it has the requisite competence, experience and resources to analyse the issues and risks involved in overseas investment, to develop, implement and keep up-to-date a set of effective internal controls and risk management system to deal with existing and foreseeable risks involved in overseas investments, and to inform investors in a clear, concise and timely manner of the investment profile and risks of a REIT. It shall submit a detailed business plan to the Commission to demonstrate how it can implement its investment strategy, given its resources and circumstances.
11. In assessing whether a management company is capable of engaging in overseas property investments and management, the Commission will consider factors such as:
  - (a) the composition of the management team;
  - (b) the expertise of the key personnel and senior management, and the competence, knowledge and experience of staff and their ability to devote their time and attention to investing in and managing the

- properties in the jurisdiction(s) and the type(s) of properties that the REIT invests or proposes to invest in;
- (c) the regulatory and/or disciplinary records of the management company and its key personnel, as a manager of a collective investment scheme or a listed vehicle;
  - (d) the track record of the management company in investing in and managing the type(s) of properties in the jurisdiction(s) that it intends to invest in;
  - (e) the operating system and compliance standards of the management company;
  - (f) the accounting and internal controls systems of the management company;
  - (g) the contingency plans of the management company to deal with exigencies that may arise in overseas jurisdiction(s) and to address any consequential impact that may affect the REIT's investments in such jurisdiction(s);
  - (h) the financial resources of the management company; and
  - (i) the nature and extent of technical and human resources that the management company may obtain from the group it belongs to.
12. Based on the capabilities and resources possessed by a management company, the Commission may license a management company acceptable for engaging in overseas investment, subject to imposition or variation of such conditions and/or provision of undertakings as it may from time to time deem appropriate. This is to ensure that the management company is only allowed to engage in such investments to the extent commensurate with their skills and capacity.
13. The degree of complexity that a management company has to deal with when investing in and managing overseas properties depends on the jurisdiction(s) where the properties are located. As a general rule, as the number of property increases, especially where properties are situated in different jurisdictions, the demand on the resources, expertise and internal control system of the management company multiplies. Therefore, in licensing a management company as a REIT manager that invests in overseas properties, the Commission will generally only allow it to manage one REIT and will impose such conditions as may be appropriate in the light of the unique circumstances of the management company.
14. Further conditions which may be imposed by the Commission on the management company may vary in accordance with the specific circumstances of the management company and may include restrictions on the type(s) of properties being managed, the location(s) of the properties that the management company may invest in, and the maximum size of a REIT that the management company may manage. In imposing the conditions, consideration will be given to factors such as but not limited to:
- (a) the operating history of the management company;

- (b) the extent of commitment the management company obtains from the group it belongs to in terms of transfer of technical know-how, and financial and organizational support;
  - (c) the presence of a team of professional managers with proven experience in managing a portfolio of cross-jurisdictional properties;
  - (d) the existence of an established overseas network for investing in and managing property investments;
  - (e) the track record in investing and managing a portfolio of property investments in the relevant overseas jurisdiction(s); and
  - (f) the adequacy of technical and operational resources to deal with the requirements and risks of investing in different overseas jurisdictions.
15. Licensing conditions may be reviewed and varied as and when the management company establishes its track record and can demonstrate to the Commission that it has the expertise and capability to go beyond its existing restrictions as laid down in the licensing conditions. In exceptional cases where the management company can demonstrate that it has extensive operational support, adequate key personnel with cross-jurisdictional property investment experience and management expertise, strong financial and organizational backing, and an established track record of property portfolio management for the retail public, the Commission may consider granting a licence to manage more than one REIT at the outset.
16. The management company shall have a comprehensive compliance plan that is appropriately devised to ensure that risks involved in overseas investments, such as legal, regulatory, fiscal and operational risks etc. are adequately mitigated and proper checks and balances are in place to monitor the activities performed in relation to a REIT. The management company shall also have a contingency plan that enables it to proactively respond to any exigencies that may arise in the course of its investment and management of overseas properties, its divestment of such properties and any matters arising in the course of public offering of any units in the scheme. Such compliance plan has to be submitted to the Commission.
17. Subject to compliance with the principles and rules relating to delegation in the Code and this Practice Note (including without limitation those in GP 4 and Rule 5.7 of the Code), the management company may delegate one or more functions in relation to the management of the REIT's overseas investments to an overseas partner or appoint overseas delegate and/or agent/expert (collectively "overseas entity") to perform such functions. However, it shall conduct due diligence work to ensure that such overseas entity is competent to perform the functions so delegated or appointed, and shall establish adequate measures to monitor and/or supervise the activities of such overseas entity. The management company's accountability to investors is neither diminished nor compromised as a result of such delegation or appointment. The management company remains fully responsible for the acts and omissions of the overseas entity.

*Notes: (1) The compliance plan of the management company shall clearly demonstrate that it has proper due diligence procedures and structured plans as to how an overseas entity (to whom one or more management functions are to be delegated) shall be selected and monitored on a continuous basis. Such plan shall include at a minimum the following provisions:*

- (a) the criteria and procedures for selection;*
- (b) the manner in which the management company will give instructions to an overseas entity;*
- (c) how and when the management company will receive reports from an overseas entity;*
- (d) the mechanism for regular review of the basis for selecting an overseas entity to reflect changes in relevant rules and regulations in the overseas jurisdictions;*
- (e) means to assess shortfalls in standards/performance of an overseas entity; and*
- (f) presence of a satisfactory mechanism for the management company to exit from a partnership or to terminate an appointment.*

*(2) In assessing an overseas entity, the management company shall pay special regard to:*

- (a) professional and liability insurance required to be taken out by the overseas entity in connection with the type of work carried out for a REIT and/or its underlying properties, in accordance with the relevant rules and regulations of the jurisdiction where the overseas entity operates;*
- (b) means of recourse against the overseas entity in cases of sub-standard performance or misconduct; and*
- (c) the track record of the overseas entity in investing and managing properties in the relevant jurisdiction. In this regard, the manager shall assess an overseas entity based on the principles laid down in the Code.*

*(3) Where an overseas entity is engaged to perform the function of day-to-day management of properties, the management company shall remain the key decision-maker of all material matters relating to the management of such properties.*

18. The management company shall implement appropriate measures to oversee and supervise an overseas entity. There shall also be a mechanism in place to identify and address any potential conflicts of interest of such overseas entity.

## Due Diligence in Making Overseas Investments

19. The management company shall implement appropriate policies and conduct due diligence such that investments are made only after careful and diligent investigations by the management company. All such procedures, processes and decisions made in relation to invest or not to invest in a particular country or a property by a REIT shall be properly and clearly documented as part of the record-keeping function of the management company.

*Notes: (1) The management company shall ensure that the rights of a REIT on the overseas properties are properly registered under applicable land title and property laws of the relevant jurisdiction(s) and are enforceable in the judicial system of such overseas jurisdiction(s).*

*(2) The management company shall endeavour to take out title insurance for overseas properties (where such insurance is generally available) at reasonable costs.*

*(3) When investing in overseas properties, the management company shall ensure that its investment management activities in relation to overseas property investments is covered by its professional indemnity insurance.*

20. The management company shall engage a listing agent for the purpose of an initial public offering, and where required by the Code or considered necessary, a financial adviser for the purpose of a property acquisition/disposal. However under no circumstances shall the appointment of such listing agent or financial adviser absolve the management company (including its directors and senior executives) from the responsibility of due diligence as contemplated under the Code and this Practice Note.

21. The listing agent and financial adviser are in effect assuming the responsibilities of, and discharging a function no different from, the sponsor of an initial public offering and the corporate adviser to a listed company in relation to a transaction, respectively. They therefore shall conduct their own independent due diligence on the subject properties and shall:

- (a) meet comparable standards of due diligence as those required by the Hong Kong Exchanges and Clearing Limited and the Commission from time to time in respect of sponsors or corporate finance advisers; and
- (b) adhere to the relevant codes of conduct applicable to corporate finance advisers, including sponsors and independent financial advisers, published by the Commission from time to time.

## *Country Specific Due Diligence Exercise*

22. The following paragraphs only set out some of the key areas that a management company shall pay special attention in its due diligence before investing in overseas properties and shall not be taken as exhaustive obligations, steps or standards expected of a management company in such situations.
23. The management company shall ensure that the rights and interests of the holders are protected in implementing any decisions. As in the case of making investments in Hong Kong, a management company has the duty to ensure that any decisions in relation to overseas investment or divestment are made in the best interests of the holders, taking into account various factors, including without limitation the following:
- (a) overall and thorough examination and understanding of the economic and political environment, legal, judicial and accounting systems, and the property market in the relevant overseas market;
  - (b) entrance barrier of overseas market e.g. foreign ownership restrictions, foreign exchange and remittance control, and anti-trust/competition provisions;
  - (c) the legal and regulatory framework governing the proprietary rights of investors in real estate in that jurisdiction, the effectiveness and certainty of the legal system whereby contractual and proprietary rights of real estate owners and landlords are enforced and upheld, for example, reliability and certainty of ascertaining, establishing and protecting title to real estate and the legal rights of parties to a lease, and the enforceability of leases and other real estate agreements; specific legislation, regulations or government policies securing tenants' tenure, protecting tenants or controlling rental reviews; laws governing the operations of the specific business(es) to be contemplated for operations in the property; and the level of transparency and certainty of governmental policy on real estate regulation;
  - (d) operational barriers e.g. rental collection, enforcement of legal rights as landlord and transparency of accounting and financial reporting systems;
  - (e) environmental matters e.g. regulations and any requirements for licences or consents from environmental authorities;
  - (f) taxation matters e.g. land appreciation tax or other special levy or tax for the business, withholding tax or any other taxes that may affect operations of a REIT investing in the overseas property concerned;
  - (g) where applicable, the existence of qualified overseas delegates, the ability of the management company to maintain sufficient on-going supervision of such delegates and the presence of any overseas constraints or limitations in engaging such delegates;

- (h) possible exit strategies or mechanisms for the overseas market and termination arrangements for the REIT's overseas investments; and
- (i) practical and effective measures to address the issues or mitigate the risks that may arise out of the overseas investments.

*Property Specific Due Diligence Exercise*

24. While the areas or issues in relation to which due diligence should be conducted varies according to the property, its geographical location and other circumstances, the standards of due diligence to be performed on a property shall be the same regardless of the location of the property.

*Note: It is the management company's responsibility to conduct all proper and thorough due diligence on all relevant aspects. While what are relevant aspects would depend on the nature and specific circumstance relating to the property and the jurisdiction in which it is located, relevant aspects would include matters such as:*

- (a) *the ownership and legal title of the property;*
- (b) *necessary government approvals and town planning requirements;*
- (c) *restrictions on property usage and foreign ownership;*
- (d) *safety requirements;*
- (e) *land premium requirements;*
- (f) *existence of encumbrances on the property;*
- (g) *compliance with zoning and building requirements;*
- (h) *current and prospective leases and material agreements;*
- (i) *outgoings required in maintaining and operating the property;*  
*and*
- (j) *the scope and value of the insurance in place.*

*The above list is meant to give some indication of the areas requiring due diligence but is not meant to be exhaustive.*

25. The management company shall ensure that the REIT has ownership of more than 50% in the property at all times. In making such investment, the management company shall comply with the following conditions:
- (a) the management company is able to demonstrate to the reasonable satisfaction of the trustee that such arrangement (including the decision of owning less than a 100% interest in the property) is in the interest of the holders;
  - (b) the legal opinion on the title ownership of the property shall include:
    - (i) a description of the significant terms of the joint ownership arrangement;
    - (ii) a description of the equity and profit sharing arrangements of the parties to the agreement;
    - (iii) an opinion that the relevant contract and joint ownership arrangement are legal, valid, binding and enforceable; and

- (iv) a statement as to whether the relevant joint ownership arrangement has obtained all necessary licences and consents required in the location where the subject property is located.

*Notes: (1) The management company shall ensure that proper due diligence is conducted in identifying restrictions and constraints that may limit a REIT's direct ownership of a 100% interest in a property.*

*(2) The liability of a REIT shall be proportional to its capital input, with no assumption of unlimited liability.*

*(3) The management company shall disclose to investors (whether in the offering document, circular or announcements to investors, as the case may be):*

*(a) the ownership structure of the overseas property interest and the material terms thereof;*

*(b) the identity and background of the remaining legal and beneficial owners in the property, their share in the property, transactional history of these holders with the REIT in relation to that overseas property and their relationship with any connected persons to the REIT of the joint ownership arrangement including any board of directors or its functional equivalent;*

*(c) financial, remuneration, fee-sharing or other material arrangements that have been or will be entered into between the REIT and the other owners or their affiliates;*

*(d) the management analysis of the advantages and disadvantages of investing in that overseas property via this type of ownership structure;*

*(e) a summary of the contents of the legal opinion in relation to the property;*

*(f) management analysis of the financial impact of such acquisition arrangement;*

*(g) the funding of the property investment;*

*(h) where appropriate:*

*(i) the nature of restrictions on foreign ownership and the duration of them, and the impact of such restrictions on the operations and financial position of the REIT as a whole;*

*(ii) the relevant legal opinion on the application of the overseas rules and regulations that are prohibitive on a REIT to obtain full ownership in the property; and*

*(iii) the valuer's opinion and evaluation of the impact of such prohibitions on the value of the property; and*

- (i) *any other information which may be relevant to an investor.*

#### On-going supervision and monitoring of overseas investments

26. The existing regulatory framework provides for two levels of on-going supervision, namely internal controls and supervision by the management company itself, and monitoring by the trustee.
27. The management company shall ensure that in managing a REIT with overseas investment, it has sufficient oversight of the daily operations and financial conditions of the REIT and its underlying properties.
28. The management company shall establish policies and procedures to monitor the activities of its delegates and partners on an on-going basis. There shall also be regular reviews as to whether such delegation and joint arrangement remain to be in the interest of the holders, and whether the delegates or partners are still suitable. The management company is reminded of its obligations under 5.7 and 5.8 of the Code in terms of delegation of functions.
29. The trustee has the fiduciary duty not only to hold the assets of a REIT in trust for the benefit of the holders, it also has the fiduciary duty to oversee the activities of the management company for compliance with the relevant constitutive documents and regulatory requirements. This includes ensuring that all investment activities carried out by the management company are in line with the investment objective and policy of a REIT and its constitutive documents, and are in the interest of the holders.
30. The trustee shall also make reasonable endeavours to verify the legality and authenticity of all agreements in relation to a REIT, including title deeds and documents, property contracts, rental agreements, joint venture or joint arrangement agreements, any agreements made between the management company and any overseas entities, and any other material contracts.

#### Valuation

31. The valuer appointed by a REIT (the “Principal Valuer”) shall be responsible for conducting the valuation of all properties owned by the REIT. The Principal Valuer is required to comply with the qualification requirements set out in the Code. Where the Principal Valuer is not able to conduct valuation for overseas properties owned, to be purchased or to be sold by the REIT, it shall appoint an overseas valuer in the overseas jurisdiction as its delegate to assist in preparing the valuation of that overseas property subject however to the Principal Valuer having assessed, and disclosed in the valuation report, the following:
- (a) the justification for appointment of an overseas valuer in an overseas jurisdiction including the reasons for the Principal Valuer not carrying out overseas valuation by itself or its group companies;

- (b) the characteristics of the relevant overseas property market and the availability of qualified and experienced overseas valuers in that market that can exhibit the level of standard and expertise comparable to international standards in valuation;
  - (c) the merits and disadvantages of appointing an overseas valuer and whether such appointment is to the overall benefit of the REIT and its investors; and
  - (d) whether the overseas valuer appointed can meet the independence test stated in 6.5 of the Code.
32. Notwithstanding part or all of the preparation of the valuation report of an overseas property is carried out by an overseas valuer, the Principal Valuer shall remain fully responsible for the work carried out by the overseas valuer in accordance with 6.2 of the Code and shall certify the valuation report of such overseas property for the purpose of inclusion in the offering document or circular where applicable.
33. The Principal Valuer is expected to conduct due diligence in the identification of an appropriate overseas valuer and it shall ensure that the overseas valuer possesses such experience, qualifications and independence comparable to the acceptability criteria and independence standards specified in the Code.

*Notes: (1) The overseas valuer shall have sufficient experience in conducting property valuation for the relevant type(s) of properties in the relevant jurisdiction on a regular basis.*

*(2) An overseas valuer shall only be acceptable by the Principal Valuer for preparing the valuation report if the former is subject to the oversight of a reputable national professional organization for valuers.*

*(3) The Principal Valuer shall ensure that the criteria for selecting an overseas valuer are consistently and objectively applied, regardless of the location of the overseas property.*

*(4) Where valuation is performed on an overseas property, the overseas valuer may only adopt International Valuation Standards issued from time to time by the International Valuation Standards Committee. Once adopted, the overseas valuer is expected to consistently apply the same valuation standards.*

*(5) The Principal Valuer shall ensure that the same valuation standards are applied to all properties of the same REIT.*

## **Enhanced Disclosure of Risks and Specific Overseas Issues**

34. The management company shall keep current holders and potential investors informed of any information or matters that may be relevant and important to the scheme in a timely, accurate and clear manner. The Code has laid down general principles and disclosure requirements for, among others, the offering document, circulars, announcements and valuation report. While it is expected that these principles and disclosure requirements shall not be applied differently in the case of overseas properties, paragraphs 35-44 of this Practice Note seek to supplement and elaborate on these requirements. These elaborative notes shall be equally applicable to disclosure in relation to Hong Kong properties with appropriate modification.

### Offering document and circular

35. The Code has already set out the minimum disclosure standards that a REIT has to comply with. The information required to be disclosed applies irrespective of whether investments are made in Hong Kong or overseas. The management company and its directors are jointly and severally responsible for the contents, completeness and accuracy of a REIT's offering document, circulars and any notices and announcements published or distributed and for ensuring that all material statements therein have been verified and that they comply with the relevant laws and regulations.
36. Given that local investors are generally not familiar with the characteristics and risks pertaining to overseas property investments, a REIT that invests or proposes to invest in overseas properties shall ensure that information about the overseas market and the specific overseas property is fairly, accurately and clearly disclosed according to the Code whether in the offering circular (in the case of a REIT that proposes to invest in overseas properties in its initial public offering) or the circular to holders (in the case of a REIT that seeks to expand its REIT management activities outside of Hong Kong or to diversify into additional overseas jurisdictions).
37. The following serves only as a minimum reference for enhanced disclosure of overseas market and properties. The management company shall be responsible for ensuring that the level and scope of disclosure to be made to investors are adequate having regard to the specific circumstances of each investment.
38. The management company shall ensure that the characteristics and risks of investing in the relevant property market are disclosed. The management company shall at least disclose the following:
- (a) the overseas jurisdictions that a REIT invests or will invest in, or a description of the criteria for selecting the overseas jurisdiction(s) for investment;

- (b) a detailed description of the nature and risks of making property investments in each of the relevant overseas jurisdictions, such as:
  - (i) demographics;
  - (ii) state of the economy, economic risks and foreign exchange risk;
  - (iii) political risks;
  - (iv) legal risks and tax considerations;
  - (v) policies that affect property investments and property sales;
  - (vi) overview of the property market;
  - (vii) an analysis of the specific property sector and the competitive dynamics in the rental market;
  - (viii) operational requirement; and
  - (ix) rules and regulations governing property ownership and tenancy matters;
  
- (c) an assessment of the financial aspects of overseas property investment, such as the ability to hedge against currency risks, foreign exchange controls or restrictions imposed by overseas government, taxation in respect of appreciation in property values, rental income and gains on disposal of properties, the state of the overseas capital market and access to such market, and the ability to preserve and repatriate gains, profits and capital;
  
- (d) a detailed explanation of the operational matters specific to property investments in each of the relevant overseas jurisdictions, such as its practice of rental collections and rental deposit refunds, the requirement to obtain the relevant licences, the administrative requirements laid down by the relevant governing authorities, laws governing repossession of properties, and tenant protection laws;
  
- (e) a detailed description of the expertise, experience, resources, internal controls and risk management system regarding the overseas investment activities of the REIT;
  
- (f) a detailed discussion of the business plan for investing in and managing the overseas properties;
  
- (g) a description of the REIT management activities that the management company is licensed by the Commission to perform and any applicable conditions placed on the licence;
  
- (h) a detailed description of the subject property, and an explanation of why and how it meets the established criteria for selection;
  
- (i) discussion and analysis of the characteristics of and risks of investing in the subject property or type of property, and an account of the measures in place to mitigate or minimize such risks;

- (j) where there is a significant fluctuation in exchange rates between the date of property valuation and the latest practicable date prior to publication of the relevant document, this fact together with the effect of the fluctuation on the valuation as stated in the valuation report shall be set out; and
- (k) the exit strategy in the event of divestment (including the exit from any joint ownership arrangement) and the contingency plan.

*Note: All of the above information has to be disclosed in the context of the specific characteristics and circumstances of the investments in particular overseas property or properties made or to be made by a REIT, and shall not as generic statements of investment in the property market of the relevant overseas jurisdictions.*

39. A REIT investing or proposing to invest in overseas properties shall clearly and fairly explain to investors the regulatory framework in which proprietary rights and title of such overseas real estate can be legally and properly vested in the REIT. The management company shall, with the information provided by experts, prepare a commentary to be included in the offering document or circular that covers the following aspects concerning the overseas properties:

- (a) overview of the legal framework of the relevant overseas market that governs the conveyance of proprietary and legal title of real estate (including the land and the superstructure on it) in that market;
- (b) comparison of the extent of legal protection of proprietary rights over real estate conferred by the legal system in the relevant overseas market and that of Hong Kong;
- (c) brief description of any previous restructuring, transactions and delineation of title of the overseas property that is to be or has been acquired by the REIT, for a period of not less than 5 years before the date of the latest valuation of the property;
- (d) any applicable (whether in force, announced or proposed) policy changes or government administrative measures that might have an impact on the enforcement and protection of the title of the property and any of the related proprietary rights of the property acquired or to be acquired by the REIT, and an assessment of the implication thereof on all material aspects in relation to the REIT;
- (e) any special laws protecting tenants or restricting rental reviews;
- (f) assessment and explanation by the management company of the key areas of concerns in relation to the ownership and enforcement of proprietary rights of the overseas property and the operational aspects in managing such property in view of the overseas legal and regulatory regime;

- (g) the nature and extent of title insurance acquired in respect of the property, where applicable;
  - (h) a critical assessment of the assumptions adopted by the valuer as disclosed in the valuation report, and a discussion of the material effect that any variation of those assumptions may have on the valuation figure;
  - (i) a critical discussion of any material conditions affecting the status of the legal title to the subject property as disclosed in the legal opinion in respect of such property; and
  - (j) description of all known relevant taxes and premiums which may be charged in respect of the subject property.
40. The management company shall disclose to investors details of the arrangement that has been entered into by the REIT for it to own the legal and beneficial title of that overseas property and the benefits and drawbacks of such arrangement.

*Note: The management company shall disclose, as a minimum, the information in relation to overseas properties not directly or wholly owned by a REIT, as set out in paragraph 25.*

41. To ensure that investors have a clear understanding of the manner in which overseas investments are conducted, the offering document or circular shall also clearly explain whether an overseas entity is appointed and the criteria for such appointment. The offering document or circular shall, at least, provide:
- (a) names and succinct descriptions of the overseas entities, their relationships with the operators of the REIT or with the property that the REIT invests in, and the major terms (including duration) of each of the arrangements with the respective overseas entities; and

*Note: Where an overseas entity is engaged to manage an overseas property, the details of the arrangement have to be disclosed on the same basis as described in paragraph 25.*

- (b) the due diligence process conducted in respect of the selection process; and
- (c) the basis for the delegation, the criteria for the selection of delegates and the mechanism for on-going supervision of such delegates.

### Valuation Report

42. In addition to the requirements set out in the Code and paragraph 31 of this Practice Note, a valuation report that concerns overseas properties is expected to include, as a minimum, analysis and commentary on the following aspects:

- (a) socio-economic information of the relevant market, and description of the political, environmental or any other risks associated with the relevant market;
- (b) overall structure of the relevant market including an analysis of the supply/demand situation, the market trend and investment activities;
- (c) identity, experience and professional qualification of the valuer(s) of the respective overseas properties and the relationship between the Principal Valuer and the overseas valuer(s) where the valuer(s) is(are) not the Principal Valuer;
- (d) discussion of the valuation methodology and assumptions used and justification of the assumptions;
- (e) valuation reconciliation if more than one valuation method is adopted;
- (f) material information regarding the title of the subject property as contained in the relevant legal opinion, and discussion of whether any and how legal opinions have been taken into consideration in the valuation of the relevant property;
- (g) description of the significant overseas taxes which may be charged in respect of the relevant property and their estimated financial effect on the REIT;
- (h) transaction history of the relevant property in the five years immediately preceding the date of the valuation report included in the offering document or circular ; and
- (i) the exchange rate used in connection with any figures or calculations of property valuation that involves currency exchange rates and the relevant date for the rate shall be stated.

*Notes: (1) Where a valuation report is published in summary form, the full valuation report shall be made available for inspection at the REIT's registered address. A statement has to be made in the published report to this effect.*

*(2) Where a legal opinion is required, such opinion together with copies of any document referred to therein shall be made available to the Principal Valuer and relevant the overseas valuer engaged in the valuation in respect of the relevant property prior to the completion of the valuation report.*

### Financial Statements

43. Generally accepted accounting principles practiced in overseas jurisdiction may differ from those in Hong Kong. However, in order to provide investors with a better understanding and greater comparability of the financial statements of REITs, it is of paramount importance that REITs adopt the same accounting principles regardless of whether they invest locally or overseas. Accordingly, as highlighted in the Code, financial statements of all authorised REITs must be prepared in accordance with Hong Kong Generally Accepted Accounting Principles or International Financial Reporting Standards.
44. Where the value of the properties held by the REIT as recorded in the financial statements differ to that provided by the valuer in the valuation report, a reconciliation statement shall be required to explain the differences.

**Taskforce on Overseas Real Estate Investments  
by Real Estate Investment Trusts  
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