



SOMERLEY CAPITAL LIMITED

20/F., China Building, 29 Queen's Road Central, Hong Kong

Telephone: 2869 9090 Fax: 2526 2032 E-Mail: somerley@somerley.com.hk

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

26 February 2014

Dear Sirs,

**Submission on Consultation Paper on Amendments to
the Code on Real Estate Investment Trusts (the "Consultation Paper")**

Reference is made to the Consultation Paper published in January 2014. We have acted on a number of occasions as Independent Financial Advisers to REITs, principally when acquiring properties from connected parties. We are in principle supportive to the introduction of greater flexibility in respect of investments in properties under development or engagement in property development activities, and investments in financial instruments, subject to the observations and suggestions set out below to align flexibility with other desired objectives.

Set out below are our responses to the questions listed in the Consultation Paper:-

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

Our response:

We agree that flexibility in respect of property development investments and related activities should be introduced to REITs, as it gives REITs an opportunity to target properties according to their own needs at an early phase, instead of purchasing a second-hand 'ready' property, which may not perfectly suit the REITs' objectives. The perceived higher risk of property development activities over property investment comes with the potentially higher return due to lower cost of investment in a development, which may imply that REITs may participate in bidding for land in future.

It is impossible, as a practical matter, to restrict the duration of a particular property development project. Consequently, we believe the REIT Code should expressly require additional disclosure to be made at the time the REITs undertake property development activities, and on a regular basis on the periodic financial reports of the REITs, given REITs have the primary purpose of distributing rental income. Disclosures such as the expected duration of construction, development plans and associated risks of such property development activities should be made when the REITs first undertake the property development activities. Subsequently, any material changes to initial plan should also be disclosed.



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

Our response:

We consider the 10% GAV Cap is an appropriate threshold. It may be objected that this may prove too small to be of much practical reference, but, as noted above, the risks of property development are greater than, and different in kind from, those of property investment. An increase in the threshold could be considered after an initial trial period. However, we believe there should be clarity in the proposed amendment to Note (2) to Rule 7.1, that whether the 10% GAV Cap is calculated on an enlarged basis. Note that it is stated later in the proposed amendment to Rule 7.2A that the 10% threshold should not be exceeded at all time, which implies the threshold is calculated on an enlarged basis.

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

Our response:

We believe the calculation of Property Development Costs should be consistent with relevant accounting standards which apply to the property development activities to be recorded on the financial statements of the REITs. This will ensure there is an objective basis to assess and monitor subsequent Property Development Costs by referring to the financial statements, which will be made available to the public.

When arriving at the upfront calculation of Property Development Costs, REIT managers should also take into account of expected rise of development costs for factors such as inflation. This should be an additional consideration on top of the 'prudent buffer in line with best industry standards or practices to cater for cost overruns' as stated in paragraph 17 of the Consultation Paper.

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

Our response:

We consider it adequate for any updates on the status of property development investments and related activities to be disclosed in the periodic financial reports of the REITs.

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

MS



Our response:

We believe the REIT Code should expressly provide that any property development activities to be undertaken by a REIT should be principally for long-term investment following completion of development. It seems from the current proposal that REITs can engage in business of property development and sales, as long as the 10% GAV threshold and the 2-year holding restriction are complied with. Although the 2-year holding restriction seems to be an effective deterrent, the flexibility proposed in the Consultation Paper may enable REITs to conduct property development and sale activities, for example by entering into contractual arrangements with buyers to lease a target commercial property, followed by a sale (or an option for the buyers to purchase) after maturity of restriction period.

We also note that similar amendments were proposed by the Financial Services Development Council in its research paper "Developing Hong Kong as a Capital Formation Centre for Real Estate Investment Trusts" published in November 2013 (please see suggested amendments on Rule 7.3 of the REIT Code as stated on page 33 of research paper).

Certain additional disclosure requirements should also be considered:

- Requirement of an annual review of the risk mitigation procedures as proposed in paragraph 24 of the Consultation Paper, and disclosure of the results of such review in the REITs' annual reports
- Description of the expertise and experience of the senior management of the REIT manager in property development

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

Our response:

Bearing in mind the proposed flexibility in respect of investments in financial instruments is to better manage REIT's cash position (paragraph 32 of the Consultation Paper), we have the following observations and suggestions:

- Investment in listed securities should only be limited to entities engaged in the property business, possibly using the majority of assets being property as a test (i.e. investment in dot-com companies should not be allowed)
- Investments in derivative securities, except for the purpose of hedging, should be prohibited due to the perceived higher risks compared to the normal risk profile of a REIT and possible lack of expertise of the REIT manager in this field. In this respect, we note that the holding of hedging instruments is currently allowable
- We consider "government and other public securities", and in



particular “public securities”, to be too broad a scope, which may see complications in defining “public”. We suggest limiting the scope to “debt securities issued by governmental bodies”, which are in general more conservative in nature and have comparatively a lower risk profile

We agree to set the cap of Relevant Investments to 5% of the gross asset value of the REIT. We also agree to set the Maximum Cap to 25% of the gross asset value of the REIT.

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

Our response:

We suggest that the REIT Code should expressly prohibit investment in derivatives securities except for the purpose of hedging, in order to avoid speculative trading which does not match with the risk profile of a REIT. We also suggest the REIT Code should require disclosure of any material fluctuation in valuation of the Relevant Investments. As it is already proposed in the Consultation Paper to require the Relevant Investments to have transparent pricing, monitoring of any material fluctuation in value should be fairly straightforward.

As a general comment, we note from our experience as Independent Financial Advisers attending REIT unitholders’ meetings that there are many retail holders (several hundred attending meetings) with a heavy dependency on a reliable and sustainable yield from REITs. We therefore believe that a high degree of conservatism in any changes introduced is desirable.

If you wish to discuss the above response, please do not hesitate to contact our