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

SFC
證監會

Consultation Conclusions on Amendments to the Code on Real Estate Investment Trusts

July 2014

Table of contents

Introduction

1. On 27 January 2014, the Securities and Futures Commission (**SFC**) issued a Consultation Paper (**Consultation Paper**) on Amendments to the Code on Real Estate Investment Trusts (**REIT Code**) inviting public comments on proposed amendments to the REIT Code to allow for greater flexibility in the investment scope of REITs with respect to (a) investment in properties under development or engagement in property development activities and (b) investment in financial instruments, ((a) and (b) collectively, the **Proposals**).

2. The consultation ended on 26 February 2014. The Commission received a total of 113 written submissions, including submissions from REIT managers, various industry associations, professional bodies, financial institutions, valuers, law firms, a professional trustee and individual investors. A list of respondents (other than those who requested anonymity) is set out in **Appendix B**.

3. A majority of the respondents supported the Proposals, agreeing that the Proposals would facilitate the long-term growth of the Hong Kong REIT market and are broadly in line with regulations in comparable international markets. Comments received from these respondents generally focused on seeking further technical guidance on specific matters and clarification of the suggested revisions to the REIT Code ensuing from the Proposals. For those respondents who disagreed with the Proposals, their main concern was the potential change to the recurrent income generating nature and risk profile of REITs, and there was also some concern as to the expertise of REIT managers.

4. In reviewing the responses to the Proposals, the Commission accords consideration first and foremost to the nature of REITs as a vehicle which seeks to provide recurrent rental income. The Commission is also mindful that REITs should remain distinguishable from property development companies, with their own specific characteristics and requirements as outlined in the consultation paper and conclusions published when the REIT regulatory regime was first introduced in 2003. Accordingly, the Commission considers that the Proposals, and their associated limits, should be maintained in line with the primary principle of investor protection.

5. The Commission has carefully considered the comments received. For the reasons set out in the Consultation Paper and having regard to the landscape of the Hong Kong REIT market as well as the majority support for the Proposals, the Commission considers that the Proposals and the associated amendments to the REIT Code should be adopted with certain modifications or clarification of the regulatory intent as set out in this paper. The Commission would also provide further guidance by way of a set of Frequently Asked Questions to the industry (**FAQs for the Proposals**), which will be updated from time to time.

6. This paper summarises the major comments received in the consultation process, the SFC's responses and the proposed revisions to the REIT Code.

7. The marked-up text of the amendments to the REIT Code in association with the matters set out in the consultation is set out in **Appendix A**. All these amendments will become effective once the revised REIT Code is gazetted.

8. We would like to thank all respondents for their time and efforts in reviewing the Proposals and providing us with their detailed and thoughtful comments.

9. The Consultation Paper, the responses (other than those which have requested withholding from publication) and this paper are available on the SFC website at www.sfc.hk.

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

Introducing flexibility to engage in property development

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

Public comments

10. A majority of the respondents supported the proposal to introduce flexibility in respect of property development investments and related activities (**Proposal 1**). They generally considered the proposal to be beneficial to REITs and their unitholders for the reasons similar to those outlined in the Consultation Paper, adding that REITs could, by acquiring projects at an earlier stage with lower costs, to obtain better investment returns for unitholders, offer a more sustainable solution than a major overhaul or disposal of existing property at less than optimal prices, and minimise unnecessary disturbances to the public and the tenants.

11. The respondents who agreed with the proposal also considered that the proposals are in line with the regulations in comparable overseas markets and would increase the competitiveness of the local REIT market. A number of respondents commented that investors should be provided with a choice of different REITs including those which undertake such property development investments and related activities and those which do not.

12. Some respondents, including two REIT managers and some individual respondents, disagreed with the proposal. Their reservations mainly focused on the potential change to the recurrent-income generating nature and risk profile of REITs. Some respondents were concerned that the REIT's ability to pay regular distributions may be adversely affected. Some respondents opposing Proposal 1 questioned if REIT managers have sufficient expertise, internal controls and risk management systems to undertake such investments and activities. In this connection, some respondents commented that the self-policing steps or external expertise engagement might be insufficient to guard against unidentifiable risks.

13. The opposing respondents also noted that property development might create uncertainty due to the absence of a proven record of rental income and the extra costs which may be borne by the REIT if external experts were engaged. Some were also concerned about the potential blurring between property development companies and REITs in their business models, possible distraction of REIT managers from managing properties for rental income in pursuit of short-term realization gains, and the higher risks involved if property development activities were undertaken overseas with lower costs.

Commission's response

14. As highlighted in the Consultation Paper, the Commission is mindful of the nature of REITs as an investment vehicle that primarily invests in real estate with the aim to provide returns to investors derived from recurrent rental income, and of the risks associated with property development investments and related activities.

15. In formulating the proposal, the Commission has therefore adopted a measured approach by suggesting a range of accompanying requirements and measures to maintain a clear distinction of a REIT's nature and to address relevant risks. These include but are not limited to the 10% GAV Cap, a minimum holding period of two years after completion of the property developed, a restriction on investment in vacant land, and 75% of the gross asset value (**GAV**) of the REIT is required to be invested in real estate that generates recurrent rental income at all times.

16. In relation to the expertise of REIT managers, as set out in the Consultation Paper, REIT managers must have the requisite competence, expertise, and effective internal controls and risk management systems in order to undertake such property development investments and related activities. REIT managers, given their fiduciary duties to unitholders as a whole and as SFC-licensed corporations, must exercise their professional judgement and satisfy themselves that they have sufficient and appropriate skills and processes in place before deciding to engage in these activities.

17. It would also be useful to note that the proposed measures, together with other existing requirements under the REIT Code such as borrowing limits, dividend policy, and compliance guidance concerning overseas investments, would help address the concerns raised, and continue to set REITs apart from property development companies, which are not subject to any of such constraints.

18. In light of the majority support for Proposal 1, and the additional safeguards and measures placed on Proposal 1 in maintaining the REIT's nature as mentioned above, the Commission would proceed with adopting Proposal 1.

The 10% GAV Cap threshold

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

Percentage limit of 10% GAV Cap

Public comments

19. A majority of the respondents considered that the 10% GAV Cap is appropriate and a good starting point, while some respondents did add that the percentage could be further liberalised in future in line with market development.

20. A few respondents suggested that no investment cap should be imposed at all, or that a higher threshold, e.g. at 15% or 25% of the GAV, should be imposed. One of these respondents further commented that the suggested 25% GAV threshold could be exceeded if unitholders' approval is obtained. The reasons provided generally referred to the high land and construction costs in Hong Kong and hence the 10% GAV Cap could potentially be insufficient for REITs with smaller GAV. Another respondent suggested that the 10% GAV Cap should not apply to redevelopment of existing properties which have been held for a prescribed period.

21. On the other hand, some respondents suggested a lower threshold. In particular, some of those respondents who opposed Proposal 1 suggested that if the proposal were nonetheless to be adopted, the net asset value (**NAV**) instead of GAV should be used as the calculation basis. One respondent suggested setting the threshold at 5% of the

GAV and another respondent suggested that while the 10% GAV Cap is acceptable, unitholders' approval should be obtained if the investment exceeds 5% of the GAV of the REIT. One other respondent suggested imposing a sub-cap on investments involving vacant land.

Commission's response

22. The Commission considers that the percentage limit is one of the key measures for limiting the risks to, and preserving the profile of, a REIT as a recurrent rental-income generating vehicle, having particular regard to the concerns raised by respondents in relation to Proposal 1 as set out above. In considering the percentage limit, as noted in the Consultation Paper, the Commission has considered the approach of comparable jurisdictions and their relevant limits imposed.

23. Given that the 10% GAV Cap will cover both new development projects and re-development of existing portfolios[1], Proposal 1 would be beneficial to all REITs generally. In light of the above and noting majority support of the suggested threshold, the Commission would adopt the 10% GAV Cap. The Commission would also keep in view such threshold in light of future market development.

Scope of the 10% GAV Cap

Redevelopments and acquisition of uncompleted units

Public comments

24. A few respondents suggested that investments in redevelopment projects, or investments in acquisition of uncompleted units, should be excluded from the 10% GAV Cap. They suggested that these items should be subject to separate caps so as to allow flexibility as REITs pursue suitable investment opportunities. One respondent also inquired as to whether the 10% GAV Cap could allow REITs to acquire non-vacant land with the intention of converting its permitted use followed by property redevelopment.

Commission's response

25. There are apparent similarities in the nature of and risks associated with a development project, a redevelopment project and the acquisition of uncompleted units, including for example construction risks and the impact on the REIT's recurrent income. The Commission therefore maintains the view that the proposed scope of the 10% GAV Cap should cover all of these types of investments or activities.

26. In view of their nature, acquisitions for purposes of conversion of usage and redevelopment would also be subject to the 10% GAV Cap which is applicable to both development and redevelopment projects.

Substantial asset enhancement and investments in redevelopment projects

Public comments

27. One respondent inquired as to the distinction between substantial asset enhancement and investments in re-development projects, pointing out that the 10% GAV Cap would apply to the latter only but not to refurbishment, retrofitting or renovations.

[1] As set out in the Consultation Paper, such redevelopment of properties in the existing portfolios of REITs does not include "refurbishment, retrofitting and renovations" which are currently excluded under the REIT Code.

Commission's response

28. REIT managers should exercise reasonable and professional judgement in considering whether the activity involved amounts to a re-development to which the 10% GAV Cap would apply, as opposed to a genuine refurbishment, retrofitting or renovation exercise. In this connection, REIT managers are generally expected to consider all relevant factors such as materiality, extent and duration of the activity involved as well as the impact on income generation. REIT managers are encouraged to consult the Commission in case of doubt.

Approach to calculating the 10% GAV Cap

Public comments

29. Two respondents suggested that when calculating the GAV of the REIT for the purposes of the 10% GAV Cap, the value of the investment properties under development should be included in the denominator with reference to certain accounting principles.

Commission's response

30. Given the purpose of the 10% GAV Cap is to limit the investments made to a percentage of the REIT's recurrent-income generating real estate portfolio so as to maintain the REIT's fundamental nature and risk profile, the Commission wishes to clarify that the denominator used in the 10% GAV Cap calculation should not include the value of the investment properties under development.

31. Separately, note (2) to 7.1 of the REIT Code has been revised to make it clearer that the sum total of (a) all costs associated with the acquisition of uncompleted units contemplated under note (2) to 7.1 of the REIT Code and (b) the Property Development Costs under 7.2A of the REIT Code, shall not exceed the 10% GAV Cap at any time.

Timing of calculation of 10% GAV Cap

Public comments

32. Several respondents suggested that the 10% GAV Cap requirement calculation should only be applied at the time of making an investment instead of at all times, as otherwise this could restrain REITs from conducting multiple projects or acquisitions within a period of time.

Commission's response

33. For the reasons set out in the Consultation Paper, it is important to ensure the 10% GAV Cap is complied with and not exceeded at any time (and not just at the time of making an investment) in order to maintain the overall risk profile and nature of a REIT as a recurrent rental-income generating vehicle.

Determination of Property Development Costs

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

Approach to calculating the Property Development Costs

Public comments

34. Most of the respondents who agreed with Proposal 1 were supportive of the proposal for the Property Development Costs to be calculated on an "at cost" basis covering the total project costs borne and to be borne by the REIT. A majority of these respondents also agreed that the upfront calculation of the Property Development Costs, and any increase in such costs subsequently, should be based on a fair estimate made by the REIT Manager in good faith and supported by the opinion of an independent expert acceptable to the Commission.

35. Some respondents however suggested that the total project costs should be calculated at fair value instead of "at cost" basis, based on certain accounting principles and having regard that the denominator of the 10% GAV Cap is calculated using the value of the REIT.

36. A respondent also submitted that Property Development Costs should not be calculated by the trustee.

Commission's response

37. The Commission maintains the view that the Property Development Costs should be calculated "at cost" instead of at value basis. Given that the intention of the 10% GAV Cap is to limit the exposure of the REIT in conducting property development investments and related activities rather than the value or profits generated post-completion, the "at cost" calculation basis is considered to be the appropriate approach.

38. As pointed out by industry participants, it is common for parties engaging in property development projects to calculate the amount of all potential and foreseeable costs involved in the project upfront in order to have a proper and prudent assessment of whether sufficient financial resources are available to meet the cost demands of the project. Accordingly, having regard to the purpose of the 10% GAV Cap and in view of majority support received, the Commission would proceed with the proposed calculation approach.

39. In terms of the responsibility for calculating the Property Development Costs, it should be noted that while the REIT manager would be primarily responsible for the calculation, the REIT's trustee also has the fiduciary duty to oversee the activities of the REIT manager for compliance with the regulatory requirements applicable to the REIT under the REIT Code. This would include taking reasonable care to ensure that the investment limitations applicable to the REIT are complied with.

Types of Property Development Costs

Public comments

40. Several respondents suggested for the Commission to provide a detailed breakdown of the total project costs to be borne by the REIT including for example stamp duty, capitalized financing costs/interests, professional fees, marketing costs, expected rise in costs due to inflation etc, or model a detailed list of costs with reference to certain accounting standards. A few respondents specifically inquired if financing costs would be included, with one of them suggesting exclusion.

Commission's response

41. The Commission notes that Proposal 1 clearly refers to the "total" project costs borne and to be borne by the REIT, which would therefore include all of the costs associated with the property development investments and related activities including financing costs. Given that the variety of costs involved in a particular property development or redevelopment project may differ from case to case, the reference to "total" project costs instead of a prescribed list is considered more appropriate. However, taking into account the submissions received specifically on financing costs, this item has been added to the proposed note (1) to 7.2A of the REIT Code for better clarity.

Frequency of periodic updates

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

Public comments

42. A majority of the respondents supporting Proposal 1 agreed that periodic updates on the status of property development investments and related activities should be provided to investors in the interim and annual reports of REITs as proposed. A few of the respondents did suggest more frequent, namely quarterly, updates be provided by the REIT managers.

43. One respondent commented that the requirement for a REIT manager to issue an announcement irrespective of the amount of contract may create an undue burden where the individual contractual amount is insignificant and suggested to set thresholds for such purpose.

Commission's response

44. The Commission notes that a majority of the respondents agreed with our proposed disclosure requirements and considered the frequency of periodic updates as proposed is appropriate.

45. While some respondents have argued for a more frequent disclosure, it should be noted that apart from the proposed requirements, REIT managers are also subject to the existing continuous general disclosure obligation to provide material information to investors under 10.3 and 10.4 of the REIT Code. This would include material information pertaining to the property development investments and related activities undertaken by the REIT. Accordingly, we consider that the current proposed disclosure

requirements, coupled with the general disclosure obligation under the REIT Code, would constitute an appropriate disclosure framework for Proposal 1.

Other measures in relation to Proposal 1

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?

Disclosure measures

Public comments

46. A few respondents suggested that various additional disclosures be made by REIT managers in the announcements and periodic updates about property development activities, and requested further guidance on the requisite information to be disclosed.

Commission's response

47. In respect of the scope of disclosure required, the obligation to make full and timely disclosure is one of the primary duties of REIT managers. Since each property development project may have different characteristics, the Commission does not consider it appropriate to set out a prescriptive list of items to be disclosed.

48. To further enhance transparency, the REIT Code amendments have been revised to specifically provide that in addition to a summary of all investments undertaken pursuant to the proposal, the extent to which the 10% GAV Cap has been applied should be disclosed in the REIT's interim and annual reports. Such disclosure in the annual reports should be reviewed by the audit committee of the REIT manager.

Expertise requirement

Public Comments

49. While a majority of the respondents supporting Proposal 1 considered that the ancillary measures imposed are sufficient, the Commission received comments from several respondents suggesting additional safeguards. These included the types of professional expertise that should be required of REIT managers, the manner in which any professional expertise engagement should be made, and the inclusion of more prescriptive guidance in the REIT Code.

Commission's response

50. The Commission considers that the precise extent of expertise required of a REIT manager in undertaking the property development investments and related activities should be determined by the REIT manager, exercising its professional judgement and having regard to its fiduciary duties owed to unitholders. The expertise may come from either part of the REIT manager's in-house skills or by outsourcing to a competent external professional party under its oversight. Given that the nature of and risks associated with each and every property development or redevelopment project could vary considerably, it would not be practicable to seek to list prescriptively all relevant expertise that needs to be engaged.

51. The Commission would like to stress that any decision made by the REIT manager to engage in property development investments and related activities must be made solely in the best interest of unitholders. Accordingly, the Commission would like to remind REIT managers again that they must carefully assess and ensure that they have the requisite competence, expertise and resources when partaking in property development investments and related activities.

Minimum holding period

Public comments

52. Several respondents suggested imposing a longer minimum holding period (such as four to five years) for properties completed under the REIT's property development projects in order to encourage REITs to develop properties for long-term income production.

53. Regarding the new note (2) to 7.8 of the REIT Code, one respondent also sought clarification as to whether a property after completion can be sold earlier if approved by way of a special resolution of unitholders.

Commission's response

54. The Commission takes note that a majority of the respondents agreed with the current proposal of a two-year holding period subject to unitholders' approval by special resolution for a shorter duration.

55. For the avoidance of doubt, the Commission has also fine-tuned the new note (2) to 7.8 of the REIT Code to make it clearer that, as in the case of existing properties owned by the REIT, the minimum two-year holding period to be extended to properties completed under the REIT's property development projects may be waived by a special resolution of unitholders.

Maximum development period and maximum capital commitment

Public comments

56. A few respondents suggested deploying a maximum development period, for example for five years, to reduce risks arising from a lengthy property development project. A respondent proposed that a maximum capital commitment be set for each development project.

Commission's response

57. The Commission notes that maximum durations and maximum capital commitments are not commonplace measures adopted in other comparable jurisdictions. It is also considered that a forced divestment of a half-completed property development project may not necessarily be in the interest of the REIT and the unitholders as a whole.

58. In addition, REIT managers as fiduciaries are required to take reasonable care and exercise diligence prior to undertaking property development investments and related activities, including a prudent assessment of the viable duration and capital commitment of the project. The 10% GAV Cap also serves as a measure to limit the amount of investment that may be undertaken by a REIT in property development investments and related activities. Further, investors would be kept well-informed of the latest status

of the development project under the proposed disclosure and reporting requirements. The Commission therefore does not consider it appropriate to impose a maximum development period or maximum capital commitment.

Licensing requirement

Public comments

59. A respondent suggested amending the licensing requirements for REIT managers in light of the expanded scope of activities and inclusion of requirements, such as the cap on capital commitment, for property development projects.

Commission's response

60. The Commission would like to clarify that the existing licensing requirements applicable to REIT managers would continue to apply as REIT managers would remain engaged in managing the activities of REITs which would continue to consist primarily of immovable properties.

Miscellaneous comments

61. The Commission also received comments on aspects that are corollary to Proposal 1 for which clarifications are sought. These are set out in brief below.

Connected party transactions

Public comments

62. One respondent asked whether, in the event that a REIT engaged a connected person as a relevant counterparty in the property development investments and related activities, the transaction would be considered as a connected party transaction or continuing connected party transactions.

Commission's response

63. The Commission would like to highlight that all connected party transactions, including those in relation to property development investments and related activities, would be subject to the existing requirements governing connected party transactions under the REIT Code. REIT managers are encouraged to consult the Commission in case of doubt.

Majority ownership and control

Public comments

64. Three respondents sought clarification as to the application of the majority ownership and control requirement under 7.5(aa) and 7.7A of the REIT Code and the associated Frequently Asked Questions for REITs (**FAQs for REITs**).

65. The respondents generally noted that to engage appropriate expertise and having regard to the often complex nature of property developments in Hong Kong, REITs may enter into joint venture arrangements with property developers to conduct property development investments and related activities. However, the existing requirements restrict the aggregate value of properties for which a REIT has less than majority

ownership and control to not more than 10% of the NAV of the REIT. A respondent sought clarification as to whether such restriction should be revised to 10% of the GAV having regard to the close correlation between this requirement and Proposal 1.

Commission's response

66. As explained in the current FAQs for REITs, the manager of a REIT must be able to manage and enhance the value of the properties of the REIT. Hence, it is important that the REIT has "majority ownership and control" over its properties at all times to enable the REIT manager to exercise control over the management and strategic development of the properties. In order to provide a certain degree of flexibility to cater for practical situations, the "majority ownership and control" requirement is currently subject to a *de minimus* exception. This exception allows a REIT to hold less than a "majority ownership and control" in a property provided that investments in such properties in aggregate do not exceed 10% of the NAV of the REIT. In addition, the REIT manager must demonstrate that investment in such properties is in line with the REIT's investment strategy and objectives and in the best interest of the REIT unitholders.

67. Taking into account the current Proposals, the Commission agrees that it would be appropriate to revise the current *de minimus* threshold applicable to the "majority ownership and control" requirement to 10% of the GAV for better alignment of regulation. The Commission will revise the relevant FAQs for REITs to reflect the same and to clarify technical comments received relating to this subject.

Technical drafting comments

Public comments

68. A respondent made a technical drafting comment on note (2) to 7.1 of the REIT Code. Another respondent queried whether the words "prudent buffer" are necessary in the new note (2) to 7.2A of the REIT Code. The respondent also asked for a clarification of the meaning of "material change in the overall risk profile" in the new note (4) to 7.2A of the REIT Code.

Commission's response

69. The Commission has revised the drafting of note (2) to 7.1 of the REIT Code to provide better clarity.

70. As regards the comment on the new note (2) to 7.2A, the Commission considers it necessary and appropriate to make it explicit in the REIT Code that the REIT manager must provide for a prudent buffer when calculating the Property Development Costs. This is also consistent with a number of the respondents' comments which consider such a buffer essential. Accordingly, no change would be made to note (2) to 7.2A of the REIT Code.

71. In relation to the query on the new note (4) to 7.2A of the REIT Code, the Commission considers that further elaboration would not be necessary given that the concept of "materiality" is a well-established and widely adopted regulatory concept in Hong Kong and internationally. REIT managers are encouraged to consult the Commission if in doubt.

General

72. In view of the majority support for Proposal 1 and for the reasons set out above, the Commission will proceed to adopt Proposal 1 with modifications as discussed above.

Part II: Proposal for introducing flexibility in respect of investments in financial instruments

Proposed Scope and Maximum Cap of the Relevant Investments

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

Scope of Relevant Investments

Public comments

73. A majority of the respondents supported the proposal to introduce flexibility in respect of investments in financial instruments ("**Proposal 2**") and agreed with the scope of Relevant Investments proposed. Reasons provided include that the proposal would allow REITs to better manage its cash position to enhance returns to unitholders especially in times of limited suitable property investment opportunities, and that the measures imposed on the proposal are adequate in addressing the associated risks of the proposal.

74. A number of supporting submissions noted that the proposal would provide flexibility for REIT's financial planning, particularly in times of low financing costs, such that they could manage the funding pending an opportune time to make acquisitions. Many of the supporting respondents also noted that the proposal is in line with regulations in comparable jurisdictions.

75. On the other hand, some respondents, including two REIT managers and individual respondents, disagreed with the proposal. They were mainly concerned about the lack of expertise of the REIT managers, possible expenses in engaging relevant experts, the potential for REITs to engage in speculative and high-risk investments which may increase risk exposure and affect dividend distributions. They were also concerned that the scope is too wide and may affect the REIT's focused investment strategy, undermining its fundamental nature and risk profile.

76. Suggestions were made by a considerable number of the respondents, both among those supporting and opposing to the proposal, to restrict the scope of Relevant Investments to "less risky" types of securities only so as to minimise change to the fundamental nature and risk exposure of REITs. Comments were diverse and included limiting the scope to property-related instruments, fixed income, principal-protected or short-term financial instruments, selected regions' public securities, investment grade debt securities, and listed securities only. Certain comments were also received suggesting that certain derivatives, structured products, unlisted debts and unlisted funds be specifically excluded.

Commission's response

77. As noted in the Consultation Paper, the flexibility proposed to be introduced for REITs to invest in Relevant Investments should not materially affect the nature and expected risk profile of the REIT. Specifically, restrictions are imposed on the flexibility, including requirements for liquidity, tradability and transparent pricing for the Relevant Investments. In addition, REIT managers are required to satisfy themselves that the

investments made are in the best interest of the unitholders and should not result in any material change in the overall risk profile of the REIT.

78. The Commission appreciates the concerns raised and takes note that while the suggestions as to the eligible types of permissible Relevant Investments are divergent, it is apparent that their common theme is to seek to restrict REITs from investing in speculative or high-risk financial instruments which might result in a material change to a REIT's risk profile. This accords with the Consultation Paper's stated intention, and which is now specifically added as a new note (3) to 7.2B of the amended REIT Code.

79. The new note expressly provides that the Relevant Investments should not result in any material change in the overall risk profile of the REIT. Accordingly, it is generally expected that REIT managers should not invest in any high-risk, speculative, or complex financial instruments or structured products or enter into any securities lending, repurchase transactions or other similar over-the-counter transactions. In assessing the risks involved, the REIT should take into account all relevant factors including but not limited to the creditworthiness of the issuer of the Relevant Investments. REIT managers are also reminded to ensure proper ongoing monitoring of the investments in discharging their fiduciary and compliance obligations.

80. The Commission has also carefully reviewed the various suggestions made as to the types of Relevant Investments in which a REIT may or may not invest. We believe it would not be appropriate to set out an overly prescriptive list of "low-risk" instruments in which a REIT may invest as this may result in moral hazard and potentially a false sense of security. In particular, what might be perceived as a "low-risk" instrument or "safe" geographical region may become high-risk or illiquid with the passing of time and rapidly changing market conditions.

81. It should also be noted that the REIT managers may, having due regard to their skills and resources as well as all other relevant factors, restrict themselves to a narrower scope of the Relevant Investments in the constitutive documents of their REITs. The proposed amendments to the existing investment scope of the REIT would also be subject to the approval of the unitholders by way of special resolution.

Expertise requirement

Public comments

82. One of the main concerns expressed by many respondents who disagreed with Proposal 2 was the lack of expertise of REIT managers.

83. Two respondents suggested that REIT managers should be required to demonstrate that they possess relevant expertise before they could engage in the Relevant Investments. A few respondents had reservations about the effectiveness of the proposed self-policing steps by REIT managers in selecting the Relevant Investments.

Commission's response

84. As set out in the Consultation Paper, REIT managers must satisfy themselves that the investments are in the best interest of the unitholders. They must also satisfy themselves that they have sufficient and appropriate skills, resources, risk management processes and controls in place to manage and monitor the Relevant Investments and any associated risks. REIT managers, given their fiduciary duties to unitholders as a

whole and as SFC-licensed corporations, must exercise their professional judgement to ensure compliance with these principles and obligations.

85. The Commission does not intend to impose separate specific eligibility requirements because REIT managers are SFC-licensed corporations to carry out Type 9 (asset management) regulated activities under the Securities and Futures Ordinance (**SFO**). As such, their activities are already subject to relevant legal and regulatory requirements under the SFO.

Definitions of the Relevant Investments

Public comments

86. Some respondents sought guidance on various definitions of the Relevant Investments, including for example "securities", "unlisted debt securities", "government and other public securities", "property funds", "other internationally recognized stock exchanges" and "any single group of companies".

Commission's response

87. The definitions of the Relevant Investments should generally be understood in the context of the SFO where applicable (such as "securities", "debt securities", "group of companies"), and would otherwise bear the meanings by which they are commonly understood.

88. As regards whether an overseas stock exchange would be regarded an "internationally recognized stock exchange" for the purposes of the new 7.2B of the REIT Code, the Commission generally expects the REIT manager to exercise professional judgement in its assessment in consultation with the trustee. In making such assessment, the REIT manager would generally be expected to assess whether the relevant overseas stock exchange is of a similar standing to that of Hong Kong taking into account factors such as the comparability of regulatory standards, levels of liquidity and the length of time the relevant exchange has been established.

89. REIT managers may consult the Commission in the case of doubt.

Application of the restriction requirements

Public comments

90. A few respondents inquired if the requirements for liquidity and transparent pricing for Relevant Investments could be disapplied to unlisted debt securities and property funds, which they considered may not be able to meet those requirements.

91. Several respondents also sought clarification as to whether a "see-through" approach would apply in calculating the 45% gearing limit under 7.9 of the REIT Code and the 5% limit on single group of companies exposure under Proposal 2. In other words, where

for example a REIT invests in a property fund or the securities of another company (Invested Entity), whether the borrowings of and securities held by the Invested Entity would be taken into account in calculating the aforesaid gearing limit and the 5% limit on single group of companies exposure.

Commission's response

92. The Commission considers that the requirements for liquidity and transparent pricing, together with other measures as imposed on the flexibility to invest in Relevant Investments, are important in helping to maintain the risk profile and fundamental nature of REITs. REIT managers should not invest in any financial instrument that cannot comply with any of the requirements set out in the paragraphs (i) to (iii) of the new 7.2B of the REIT Code.

93. REIT managers are expected to calculate the gearing limit under 7.9 of the REIT Code in accordance with requisite accounting standards[2], including determining whether a "see-through" approach is required.

94. However, the Commission does not in general expect that a "see-through" approach would be required for the 5% limit on single group of companies exposure in normal circumstances given any investment made by a REIT in the Relevant Investments pursuant to Proposal 2 should be in the nature of an ancillary or passive investment. It is therefore not expected that the REIT would have a substantial ownership interest in or exposure to any Invested Entity.

Percentage threshold of the Maximum Cap

Public comments

95. Respondents generally agreed with the proposed Maximum Cap. A few respondents suggested that no cap should be imposed. A few respondents had reservations about the 5% exposure limit to a single group of companies. One of them suggested that the limit could be exceeded where unitholders' approval is obtained.

96. On the other hand, several other respondents considered the Maximum Cap to be too high and suggested a lower cap ranging from 5%, 10% and 15% of the GAV. Separately, one respondent suggested limiting investments in any single class of the Relevant Investments to 10% of the GAV of the REIT.

Commission's response

97. The Commission considers that holistically, the measures in relation to Proposal 2 are adequate. Such measures include disclosure requirements to enhance transparency of the investments made, restrictions on the scope of investments that could be made, such as liquidity and transparent pricing requirements, and the REIT manager's obligations in careful selection and management of such investments. In addition, the trustee is under a general fiduciary duty to oversee the activities of the REIT manager for compliance with the regulatory requirements applicable to the REIT pursuant to the REIT Code.

98. Taking into account the comments received and similar regulatory practice in comparable overseas jurisdictions as explained in the Consultation Paper, the Commission would proceed to adopt 25% of GAV of the REIT as the Maximum Cap.

[2] Under the REIT Code, the financial statements of a REIT are required to conform with either: (a) accounting standards approved by the Hong Kong Institute of Certified Public Accountants and laid down in the Hong Kong Financial Reporting Standards issued from time to time by that Institute; or (b) International Financial Reporting Standards as promulgated from time to time by the International Accounting Standards Board.

Scope of the Maximum Cap

Public comments

99. Several submissions were received suggesting an amendment to note (1) to 7.2B of the REIT Code to the effect that plant, machinery and equipment, fixtures, furniture and fittings should not fall within "other miscellaneous non-real estate holdings" under the Maximum Cap but instead be regarded as part of the 75% real estate investment of the REIT. The respondents noted that these asset items arise in the normal course of business of a REIT and are generally considered as part-and-parcel of the properties of the REIT. They also noted that in light of the nature of such asset items, these items are accounted for as part of the property valuation under relevant accounting principles.

100. A few respondents commented that hedging instruments should be similarly excluded from "other miscellaneous non-real estate holdings" under the Maximum Cap. It was submitted that such instruments are treasury tools applied by REITs to manage interest rate and currency exposures, for example to manage the risks of investments and borrowings.

101. A respondent suggested excluding property funds from the Maximum Cap, and including such investments within the 75% investment in real estate with recurrent rental income.

Commission's response

102. Having regard to the respondents' submission, the Commission is prepared to exclude plant, machinery and equipment, fixtures, furniture and fittings provided that they are included as part of the real estate of the REIT in its valuation and accounted for as such in accordance with requisite accounting standards[3]. In this case, such items could be considered as part-and-parcel of the properties of the REIT. Revisions have been made to note (1) to 7.2B of the REIT Code correspondingly.

103. The Commission is also prepared to exclude plain vanilla hedging instruments in the nature of treasury tools for REITs to manage interest rate and currency exposures . It should however be stressed that the exclusion would be strictly limited to those instruments to the extent used for genuine hedging purpose in connection with the ordinary course of business of a REIT and not with the aim of yield enhancement. Corresponding amendments have been made to note (1) to 7.2B of the REIT Code.

104. As set out in the Consultation Paper, the Commission believes that it is important to maintain a REIT's nature as a vehicle which primarily invests in real estate which generates recurrent rental income. Accordingly, the Commission does not consider it appropriate to exclude property funds from the Relevant Investments.

Application of the Maximum Cap

Public comments

105. A few respondents inquired whether the Maximum Cap would apply in a takeover situation. In particular, two respondents noted that if it so applies, this will prohibit REITs from undertaking takeover exercises.

[3] Please refer to footnote 2.

106. One respondent inquired if the scope of the Relevant Investments could be used by a REIT to finance property developers which the REIT engages to undertake a property development project in order to generate a yield during the development period, which sometimes known as a "fund-through arrangement".

Commission's response

107. As stated in the Consultation Paper, the main purpose of Proposal 2 is to enable a REIT to better manage its cash position in the interest of unitholders. It should not be applied as a tool for takeovers or financing development companies.

108. It should also be noted that there are existing requirements governing takeovers activities under the REIT Code. These include requirements that the Takeovers Code must be complied with and the trustee and/or the REIT manager shall consult with the Commission as soon as practicable on the manner in which such activities could be carried out so that it is fair and equitable to all unitholders[4].

109. In addition, where a financing arrangement is undertaken by the REIT to the effect that it would acquire an interest in a property under development, the 10% GAV Cap imposed on property development investments and related activities would apply to such an arrangement. This should be observed regardless of the manner in which such financing arrangement is made, including the "fund-through arrangement" referred to by the respondent.

75% of the GAV shall be invested in real estate that generates recurrent rental income

Public comments

110. Two respondents inquired about how the requirement that "at least 75% of the GAV of the scheme shall be invested in real estate that generates recurrent rental income at all times" would apply where some real estate assets might be temporarily out of income as a result of refurbishment or renovation activities, or subject to rent-free arrangements. Two respondents also sought clarification as to whether this 75% minimum real estate investment would include the investments made under the Proposals.

Commission's response

111. The requirement for a REIT to be invested in income generating real estate is a well-established requirement of the regulatory framework since its inception and no particular difficulties in its application or compliance have been noted. Given the potentially wide range of the scale and nature of the refurbishment and renovation activities that may be undertaken by REITs, it would be impracticable for the Commission to provide exhaustive guidance as to when a particular refurbishment or renovation activity would result in a departure from the "rental income generating" nature. REIT managers are expected to exercise their reasonable and professional judgement in considering whether the activity involved is "temporary" and remains consistent with a REIT's recurrent rental-income generating nature as part of its normal course of business.

112. The Commission also clarifies that the 75% minimum investment would <u>not</u> include investments undertaken under the Proposals, which themselves are subject to the

[4] 11.12 of the REIT Code.

Maximum Cap. REIT managers are encouraged to consult the Commission if in doubt as to the application of the 75% minimum real estate investment requirement.

Other measures in relation to Proposal 2

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

Disclosure requirements

Public comments

113. A majority of the respondents supporting this proposal considered that the measures proposed to be imposed on Proposal 2 are sufficient. Some respondents did however seek further clarifications and more detailed guidance on the proposed measures.

114. Several respondents suggested various additional disclosure requirements in relation to the Relevant Investments. Some also suggested more frequent valuation and disclosure of such valuation.

115. A few respondents disagreed with the proposed transparency measure and disclosure requirements. In particular, they suggested a removal of the monthly publication requirement, a general simplification of the disclosures required or an inclusion of materiality tests before the disclosure requirements are triggered. They were of the view that it would be onerous for REITs to comply with the proposed requirements and mandating compliance could result in an increased administrative workload as well as create a potential hindrance for REITs to trade fairly. Some of these respondents commented that the proposed disclosure requirements may not be practicable for unlisted debt securities or unlisted property funds.

Commission's response

116. The Commission takes note that a majority of respondents considered the proposed disclosure requirements appropriate and necessary given the concerns as to the potential impact of Proposal 2 on the nature and risk profile of REITs.

117. Given that any unlisted debt securities or unlisted property funds that a REIT manager may invest in must meet the various requirements in paragraphs (i) to (iii) of 7.2B of the REIT Code (such as being sufficiently liquid and have transparent pricing), REIT managers should not have major practical difficulties in complying with the disclosure requirements. Accordingly the Commission would maintain the disclosure requirements as set out in the Consultation Paper.

118. In relation to the additional disclosure requirements suggested, the Commission notes that a majority of the respondents in support of Proposal 2 considered the disclosure requirements appropriate. It is also noted that REIT managers are subject to the existing continuous general disclosure obligation to provide material information to investors under 10.3 and 10.4 of the REIT Code. This would include material information pertaining to the Relevant Investments undertaken by the REIT. To further enhance transparency, the REIT Code amendments have been revised to specifically provide that in addition to a summary of all Relevant Investments undertaken, the extent to which the Maximum Cap has been applied should be disclosed in the REIT's

interim and annual reports. Such disclosure in the annual reports should be reviewed by the audit committee of the REIT manager.

119. The Commission considers that the proposed disclosure requirements for Proposal 2, coupled with the general disclosure obligation under the REIT Code, constitute an appropriate disclosure framework for this proposal.

Calculation methods for disclosure of Relevant Investments

Public comments

120. Some of the respondents inquired as to how the value of the Relevant Investments should be calculated for disclosure purposes, including for example whether monthly marked-to-market valuations are required. They also cited potential difficulties in disclosing the value of unlisted debt securities and property funds.

Commission's response

121. The Commission notes that there is established market practice for the valuation of the Relevant Investments. In line with GP7 of the REIT Code, REIT managers are expected to ensure such investments of the REIT are independently and fairly valued on a regular basis in accordance with the REIT's constitutive documents, in consultation with the trustee. In particular, valuation of the Relevant Investments should be made in accordance with requisite accounting standards[5] as well as best industry standards and practice. Note (4) to 7.2B of the REIT Code has been added to reflect the same.

Other additional requirements

Public comments

122. One respondent suggested that a time limit should be imposed on the investments made.

123. Two respondents inquired as to whether separate requirements apply to investments in the securities of connected parties.

Commission's response

124. In relation to the proposal to prescribe a time limit on the Relevant Investments, the Commission notes that this may not always be in the interest of unitholders, for example REITs might be forced to dispose of the investments in adverse market conditions if a time limit is imposed.

125. The Commission confirms that the existing requirements under the REIT Code governing connected parties transactions and conflicts of interests would apply to all transactions entered as a result of the implementation of the Proposals.

General

126. In view of the majority support for Proposal 2 and for the reasons set out above, the Commission will proceed to adopt Proposal 2 with modifications as discussed above.

[5] Please refer to footnote 2.

Part III: Other miscellaneous comments

Independent expert opinion

Public comments

127. Some technical comments were received in relation to the independent experts who are acceptable to provide an opinion in support of the calculation of the Property Development Costs. These include adding references to qualified quantity surveyors and members of the Royal Institution of Chartered Surveyors (**RICS**) as acceptable experts. A professional body has also drawn our attention to the updated title of their members and the reference to the valuation standards.

128. Several respondents suggested incorporating the names of specific acceptable independent experts in the REIT Code or otherwise that a list of acceptable independent experts should be issued by the Commission. A few comments were also received as to the additional or alternative benchmarks to be accepted for such expert opinions, apart from the valuation standards set out in the REIT Code.

Commission's response

129. As set out in the Consultation Paper, the Commission is prepared to accept an opinion of an independent expert acceptable to the Commission. Such independent expert is not prescribed exhaustively. While the Commission is generally prepared to accept an opinion by the principal valuer of a REIT or other experts whose key personnel are members of the HKIS, the Commission would also accept other professional experts provided that they are able to demonstrate to the Commission that they have the relevant competence and expertise to give the opinion.

130. As to the suggested benchmarks to be accepted for preparing the expert opinion report, the Commission considers that the valuation standards as set out in the REIT Code are well-established but the Commission may consider other suggested benchmarks on a case-by-case basis taking into account relevant supporting justifications.

131. Separately, the Commission has updated references to the title of the members of the Hong Kong Institute of Surveyors and the valuation standards set out in the REIT Code. Having considered the submissions received, we have also revised the relevant provisions in Chapter 6 of the REIT Code concerning the criteria for acceptability of principal valuer of REITs to include professional members of RICS (Hong Kong Branch) to align with the valuer's eligibility requirements under the Listing Rules.

Conflicts of interests

Public comments

132. Commented that a majority of Hong Kong REITs are connected to major property developers in Hong Kong, one respondent was concerned about conflicts of interests between REIT managers participating in property development projects and the major affiliates of these managers.

133. Another respondent was concerned that a REIT manager may "mix" other businesses of its affiliated companies with the business of the REIT. The same respondent suggested that only newly established and/or a separate class of REITs should be

allowed to engage in property development investments and related activities. A separate respondent inquired if the charging of manager's fees when undertaking Proposal 1 may lead to conflicts of interests.

Commission's response

134. Good governance and avoidance of conflicts of interests is a fundamental principle under the REIT Code. The REIT Code contains specific requirements that transactions entered into by the management company for the REIT shall be at arm's length and on normal commercial terms[6]. There are also detailed provisions in the REIT Code governing connected party transactions, including disclosure, reporting and/or independent unitholders' approval requirements[7].

135. REIT managers are required to comply with the REIT Code at all times, acting always in the best interest of the REIT unitholders. It is also the duty of the REIT's trustee to provide an additional layer of oversight over the activities of the REIT manager for compliance with the applicable requirements. As such, the Commission is of the view that there are appropriate and adequate measures in place to deal with conflicts of interests.

136. In addition, the manager's fee structure would be set out in a REIT's constitutive documents and charged accordingly. Changes to the manager's fee structure would require amendments to the constitutive documents which would require unitholders' approval under the REIT Code.

Breach of 10% GAV Cap and Maximum Cap

137. A few respondents sought further guidance on the remedies of a breach of the 10% GAV Cap and Maximum Cap, including whether or not the REIT must divest its investments in particular those for property development projects.

138. A respondent inquired whether an additional buffer may be provided in certain circumstances where there is a passive breach due to a decrease in value of the REIT's assets. One respondent suggested that if the Maximum Cap is exceeded, this could be "waived" by way of unitholders' approval. Another respondent also suggested that a grace period be given.

Commission's response

139. REIT managers, given their fiduciary duties to unitholders as a whole and as SFC-licensed corporations, must exercise their professional judgement in line with best industry standards and practice to include a prudent buffer for the limits prescribed in the REIT Code. If in the unforeseen event that the relevant threshold is breached, the REIT manager is expected to use reasonable endeavours to rectify the breach or take reasonable measures to do so as soon as reasonably practicable, and to keep investors informed. REIT managers should note that breaches of the REIT Code 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. The Commission will take appropriate regulatory action in case of non-compliance.

[6] GP 6 of the REIT Code

[7] The key provisions are set out in Chapter 8 of the REIT Code

140. Given the importance of maintaining the prescribed limits at all times, and that the cause of the breach together with the appropriate method of remedy may vary in different cases, the Commission does not propose to set out prescriptively in the REIT Code the remedies for different types of breaches. Similarly, the Commission does not propose to provide for additional buffers for breach of the relevant thresholds.

141. The Commission is mindful that divestment of a property development project which has already commenced may not necessarily be in the interest of the REIT and its unitholders. As set out in the Consultation Paper, where the limit is breached, the REIT manager should inform the Commission in writing immediately, issue an announcement to inform unitholders as soon as reasonably practicable, and provide information on the magnitude of and the reasons for the breach and the proposed rectification plan, including the proposed period for rectification to be completed.

Amendment of Trust Deed

Public comments

142. A respondent suggested the Commission to provide further specific guidance on the amendments that are expected to be made to the trust deeds to facilitate a uniform set of changes across all REITs.

Commission's response

143. Whether and how a REIT should revise its constitutive documents would vary depending on whether, and to what extent, the REIT intends to engage in the flexibilities granted under the Proposals and the existing wording of the particular constitutive documents. In this connection, REIT managers are reminded that before they decide to undertake any investment pursuant to the Proposals after implementation, they must first amend the existing investment scope set out in the constitutive documents of their REITs to empower the REIT managers to undertake such investments. These amendments to the constitutive documents would require the approval of unitholders by way of a special resolution.

144. The Commission considers that consistent with existing practice, the REIT managers should carefully consider how the constitutive documents of the REIT should be revised to achieve compliance with the regulatory and legal requirements in consultation with the trustee of their REITs.

General guidance

145. The Commission has received a considerable number of responses seeking practicable guidance on the detailed application of the Proposals. We would provide further guidance on these matters where appropriate through the FAQs for the Proposals, which will be updated from time to time.

Others comments relating to aspects not covered in the Consultation Paper

146. Apart from comments from respondents in relation to specific questions raised in the Consultation Paper, the Commission also received comments concerning issues not covered in the Consultation Paper, including comments in relation to tax, stamp duty, legislative changes, gearing limits and management structures[8] of REITs.

[8] SFC-authorised REITs may adopt either an internal management structure or an external management structure. There are both types of REIT structures in Hong Kong at present.

147. As these matters are beyond the ambit of the current consultation exercise, they would not be addressed in this paper. The Commission will, where appropriate, take them into broader consideration during our regular review of the general REIT regulatory regime in Hong Kong from time to time.

Conclusion and way forward

148. In view of the general support from respondents, the Commission will proceed to implement the Proposals with certain modifications and clarification of the regulatory intent as set out in this paper. A marked-up version of the text of the amendments to the REIT Code incorporating the amendments discussed in this paper together with minor amendments for greater clarity and consistency is set out at Appendix A to this paper.

149. These amendments will be adopted and become effective once the revised REIT Code is gazetted.

150. Again, the Commission would like to take this opportunity to thank all respondents for their submissions.

Appendix A

Final form of amendments to REIT Code

The highlighted parts indicate revisions to the REIT Code which differ from the proposed amendments set out in the Consultation Paper

Explanatory Notes:

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

This Code on Real Estate Investment Trusts together with the Practice Note(s) issued from time to time ("Code") establish guidelines for the authorisation of a collective investment scheme which is a real estate investment trust ("REIT").

The Commission is empowered under section 105(1) of the SFO to authorise 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 authorisation of a REIT, or of an advertisement or invitation relating thereto, and may modify, add to or withdraw any of the conditions of such authorisation, or revoke the authorisation, as it considers appropriate.

The Commission may modify or relax the application of a requirement in this Code if it considers that, in particular circumstances, strict application of the requirement would operate in an unduly burdensome or unnecessarily restrictive manner.

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

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

Chapter 2: Interpretation

2.16A "Property Development and Related Activities" refers to the acquisition of uncompleted units in a building by the scheme and property developments (including both new development projects and re-development of existing properties) undertaken in accordance with Chapter 7 in this Code.

Chapter 6: Property valuer

General Obligations of a Principal Valuer

6.3 The valuation methodology shall follow the "Valuation Standards on Properties" published from time to time by the Hong Kong Institute of Surveyors or the International Valuation Standards issued from time to time by the International Valuation Standards ~~Committee~~ Council. Once adopted, the same valuation standards shall be applied consistently to all valuations of properties of the same REIT.

Criteria for Acceptability of the Principal Valuer

6.4 The Principal Valuer shall be a company that:

(a) provides property valuation services on a regular basis;

(b) carries on the business of valuing real estate in Hong Kong;

(c) has key personnel who are fellows or ~~associate~~ members of the Hong Kong Institute of Surveyors or the Royal Institution of Chartered Surveyors (Hong Kong Branch) and who are qualified to perform property valuations;

Chapter 7: Investment Limitations and Dividend Policy

Core Requirements

7.1 The scheme shall primarily ~~only~~ invest in real estate.

Notes: (1) The real estate shall generally be income-generating. At least 75% of the gross asset value of the scheme shall be invested in real estate that generates recurrent rental income at all times.

(2) The scheme may acquire uncompleted units in a building which is unoccupied and non-income producing or in the course of substantial development, redevelopment or refurbishment, but (a) the aggregate contract value of such real estate together with (b) the ~~value~~Property Development Costs ~~of the investments in properties under development and property development activities~~ described in 7.2A below shall not exceed 10% of the gross ~~total net~~ asset value of the scheme ~~at the time of acquisition~~at any time. The aggregate contract value referred to under (a) above shall comprise all costs associated with the acquisition pursuant to the contracts entered into for such purpose.

(3) The offering document shall clearly disclose if the scheme intends to acquire further properties during the first 12 months from listing.

7.2 The scheme is prohibited from investing in vacant land unless the management company has demonstrated that such investment is part-and-parcel of the property development ~~activities~~ which may be undertaken pursuant to 7.2A below and within the investment objective or policy of the scheme. ~~or engaging or participating in property development activities. For this purpose, property development activities do not include refurbishment, retrofitting and renovations.~~

7.2A A scheme shall not engage or participate in ~~p~~Property ~~d~~Development and Related ~~a~~Activities unless the aggregate investments in all property developments~~properties under development and property development activities~~ undertaken by the scheme ("Property Development Costs"), together with the aggregate contract value of the uncompleted units of real estate acquired pursuant to Note (2) to 7.1 above, shall not exceed 10% of the gross asset value ("10% GAV Cap") of the scheme at ~~all times~~any time. For this purpose, investment in Property Development and Related Activities ~~properties under development and property development activities~~ do not include refurbishment, retrofitting and renovations.

Notes: (1) Property Development Costs refers to the total project costs borne and to be borne by the scheme, inclusive of the costs for the acquisition of land (if any), and the development or construction costs and financing costs. The upfront calculation of Property Development Costs and where necessary any subsequent increase should be based on a fair estimate made by the management company in good faith and supported by the opinion of an independent expert acceptable to the Commission.

(2) The management company is expected to include a prudent buffer in line with best industry standards ~~or~~and practice~~s~~ to cater for cost overruns that may arise during the course of development.

(3) Any decision made by the management company to invest in Property Development and Related Activities~~properties under development or to engage in property development activities~~ must be made solely in the best interest~~s~~ of unitholders.

(4) The investments in Property Development and Related Activities~~properties under development or property development activities~~ should not result in a material change in the overall risk profile of the scheme.

(5) To invest in ~~properties under development or to engage in property development activities~~Property Development and Related Activities, the management company must have the requisite resources, competence, expertise, effective internal controls and risk management system for conducting such investments or activities.

(6) Generally, the management company is expected to consult the trustee and issue an announcement to inform unitholders upon the scheme entering into a contract to invest in ~~properties under development or to engage in property development activities~~Property Development and Related Activities and to provide periodic updates in the interim and annual reports of the scheme. The management company shall ensure that all material information concerning these property development investments and related activities is set out in such announcements and periodic updates. The periodic updates shall also include the extent, in percentage terms, to which the 10% GAV Cap has been applied. Such disclosure in the annual reports shall be reviewed by the audit committee of the management company..

7.2B The scheme may, subject to the provisions in its constitutive documents, invest in the following financial instruments ("Relevant Investments"):

a. securities listed on the Exchange or other internationally recognized stock exchanges;

b. unlisted debt securities;

c. government and other public securities; and

d. local or overseas property funds;

provided that:

(i) the value of a scheme's holding of the Relevant Investments issued by any single group of companies ~~may~~would not exceed 5% of the gross asset value of the scheme;

(ii) the Relevant Investments should be sufficiently liquid, could be readily acquired/ disposed of under normal market conditions and in the absence of trading restrictions, and has transparent pricing; and

(iii) at least 75% of the gross asset value of a scheme shall be invested in real estate that generates recurrent rental income at all times.

Notes: (1) The combined value of the Relevant Investments, together with other ~~miscellaneous~~ non-real estate ~~holdings~~assets of the scheme, when aggregated with (a) all of the Property Development Costs pursuant to 7.2A and (b) the aggregate contract value of the uncompleted units of real estate acquired pursuant to Note (2) to 7.1, should not exceed 25% of the gross asset value ("Maximum Cap") of the scheme at any time. The management company is expected to manage the Relevant Investments and monitor them on an on-going basis to ensure that the Maximum Cap~~such 25% limit of the gross asset value of the scheme~~ should be observed. Hedging instruments for genuine hedging purpose as well as real estate related assets (e.g. plant and equipment) included as part of the real estate of the scheme in its valuation and financial statements may be disregarded as "other non-real estate assets" above.

(2) To provide transparency on the Relevant Investments which may be made by a scheme, the management company shall publish the full investment portfolio of the Relevant Investments of the scheme with key information relevant to such Relevant Investments (e.g. credit ratings of the instruments invested, if applicable) on its website on an ongoing basis which shall be updated monthly within five business days of each calendar month end. ~~Such information shall also be included in T~~the annual and interim reports of the schemes shall also include such information together with the extent, in percentage terms, to which the Maximum Cap has been applied. Such disclosure in the annual reports shall be reviewed by the audit committee of the management company.

(3) Investments in the Relevant Investments should not result in any material change in the overall risk profile of the scheme. Accordingly, it is generally expected that management companies should not invest in any high risk, speculative, or complex financial instruments, structured products or enter into any securities lending, repurchase transactions or other similar over-the-counter transactions. In assessing the risks involved, the management company should take into account all relevant factors including but not limited to the creditworthiness of the issuer of the Relevant Investments. The management company should also monitor these investments on an ongoing basis to ensure compliance with all applicable requirements.

(4) The Relevant Investments of the scheme must be independently and fairly valued on a regular basis in accordance with the scheme's constitutive documents, in consultation with the trustee. In particular, valuation of the Relevant Investments should be made in accordance with applicable

accounting standards adopted for preparing the scheme's financial statements as well as best industry standards and practice.

Holding Period

7.8 The scheme shall hold each property within the scheme 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.

Notes: (1) In the case where a property is held through a special purpose vehicle, this provision applies as well to the disposal of any interest in such special purpose vehicle.

(2) In the case of investments in properties under the scheme's property developments ~~activities~~undertaken pursuant to 7.2A, ~~the scheme shall hold such properties within the scheme~~this provision applies as well to the holding and disposal of such properties for a period of at least two years from the completion of the properties.

Chapter 10: Reporting and Documentation

Announcements

10.4 The following are examples of information that would require disclosure under 10.3. These examples do not constitute a complete list:

(x) a proposal to terminate the scheme; ~~or~~

(y) a proposal to vary the intention stated regarding acquisition of properties within the first 12 months of listing (see Note (3) to 7.1); or

(z) a scheme enters into a contract to invest in ~~properties under development or to engage in~~ P~~p~~roperty D~~d~~evelopment and Related A~~a~~ctivities pursuant to 7.2A.

Appendix B

Investment Objectives and Restrictions

B2 The offering document of the scheme shall clearly include:

(a) the investment policy and strategy of the scheme;

(b) the proposed use of the monies raised from the public offering of the units in the scheme and any business plan for the scheme;

(c) a discussion of the business plan for property investment and management covering 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);

(d) the general character and competitive conditions of all real estate now held or intended to be acquired by the scheme and how it meets the established criteria for selection;

(e) the nature and risks of making property investments including those pursuant to 7.2A in each of the relevant locations, including:

(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) 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;

(ea) the nature and risks of making investments pursuant to 7.2B;

Appendix C

Contents of Financial Reports

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

1. Manager's discussion and analysis of financial conditions and results of operations, explanation of any potential conflicts of interest and the manner in which they are dealt with; 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;

2A. Summary of all investments in Property Development and Related Activities pursuant to 7.2A and summary of all investments in Relevant Investments pursuant to 7.2B;

2B. The extent (in percentage terms) to which each of the 10% GAV Cap and the Maximum Cap has been applied pursuant to Note (6) to 7.2A and Note (2) to 7.2B respectively;

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

1. Manager's discussion and analysis of financial conditions and results of operations, and discussions on the outlook for the coming half-year;

2. List of real estate held by the scheme;

3. Summary of real estate sales and purchase, as well as connected party transactions during the interim period;

3A. Summary of the items discloseable for annual reports under 2A above during the interim period;

3B. The extent (in percentage terms) to which each of the 10% GAV Cap and the Maximum Cap has been applied pursuant to Note (6) to 7.2A and Note (2) to 7.2B respectively;

Income Statement

The income statement shall separately disclose, where applicable, at least the following items:

4. Profit or loss on disposal of any investment real estate

4A. Profit or loss on the holding and disposal of any Relevant Investment

Appendix B

List of respondents

(in alphabetical order)

1. Advocacy Business Consulting
2. Anonymous
3. APG Asset Management Asia
4. ARA Asset Management (Fortune) Limited
5. Au Mei Hing
6. Asia Pacific Real Estate Association Limited
7. Bob Lee
8. Carol Choy Ping-Kuen
9. CBRE Limited
10. Cecilia Chiu
11. Chan Hok Fung
12. Chuck Chang
13. CompliancePlus Consulting Limited
14. Eagle Asset Management (CP) Limited
15. Far East Consulting Engineers Limited
16. Franshion Properties (China) Limited
17. Gary Fong
18. Great Eagle Holdings Limited
19. Henderson Sunlight Asset Management Limited
20. Hong Kong General Chamber of Commerce
21. Hong Kong Institute of Surveyors
22. Hong Kong Investment Funds Association
23. Jetline Company Limited

24. Jones Lang LaSalle Limited

25. Joseph P.C. Lee & Associates in association with Cadwalader, Wickersham & Taft LLP on behalf of five financial institutions:

    (a) CIMB Securities Limited

    (b) Citigroup Global Markets Asia Limited

    (c) Deutsche Bank AG, HK Branch

    (d) Goldman Sachs (Asia) L.L.C.

    (e) Merrill Lynch Far East Limited

26. Julius Chau

27. Kaul Mayank

28. Kin Shing (Leung's) General Contractors Limited

29. Knight Frank

30. Lee Yiu Kwan

31. Leung Wing Man

32. LHIL Manager Limited and Langham Hospitality Investments Limited

33. Mandy To

34. Martin Lea

35. National Association of Real Estate Investment Trusts

36. Pat Davie Ltd

37. Paul Tsang

38. Pegasus Fund Managers Limited

39. Peter Ng

40. PricewaterhouseCoopers

41. Professor James Kenneth Pong

42. Real Estate Equity Securitization Alliance

43. Regal Portfolio Management Limited

44. Royal Institution of Chartered Surveyors

45. Shell Electric Holdings Limited

46. Somerley Capital Limited

47. Suen Chi Wai

48. Sylvia Tang

49. The Law Society of Hong Kong

50. The Link Management Limited

51. The Lion Rock Institute

52. Urban Land Institute North Asia Council

53. Vigor (M&E) Engineering Consultants Limited

54. Wing Tai Properties Limited

55. Wong Pu Sze

56. 吳先生

57. 朱小姐

58. 許小姐

59. 陳先生

60. Submissions of 25 respondents are published on a “no-name” basis upon request

61. Submissions of 29 respondents are withheld from publication upon request