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Investment Products Department
The Securities and Futures Commission
8/ F Chater House
8 Connaught Road Central
Hong Kong

Dear Sirs,

MACQUARIE

MACQUARIE GROUP'S RESPONSE TO THE CONSULTATION PAPER ON DRAFT PRACTICE NOTE ON OVERSEAS INVESTMENTS BY SFC-AUTHORISED REITS

We are responding to the Securities and Futures Commission's (***SFC***) invitation to market participants and interested parties to submit written comments on the Consultation Paper on Draft Practice Note on Overseas Investments by SFC-Authorised Real Estate Investment Trusts (***Consultation Paper***). We are making this submission on behalf of the various entities related to the Macquarie Bank Group that are interested in the development of the real estate investment trust (***REIT***) market in Hong Kong (***HK***), namely, Macquarie Bank Limited, Macquarie Real Estate Asia Limited, Macquarie Funds Management Hong Kong Limited, Macquarie Goodman Management Limited, Macquarie Goodman (Hong Kong) Limited, Macquarie (Hong Kong) Limited and Macquarie Securities Limited (hereafter collectively referred to as ***Macquarie Group***).

Macquarie Group fully supports the "basic principles" outlined by the SFC in the Executive Summary of the Consultation Paper.

A. Responses to specific issues requested by the SFC:

(1) Based on the experience of REITs in other jurisdictions, do you think that the limit on gearing ratio should be raised to 40%-50%, from the current 35% stated in the Code?

Any move to allow market forces to dictate matters such as gearing levels held by HK REITs would be supported. In the absence of removing the gearing restrictions altogether, we would support these being relaxed to 50%, as this would be a positive for the development of the HK REIT market and would not be inconsistent with other markets (e.g. US REITs).

In Australia and the US, there is presently no gearing limit imposed on listed property trusts (***LPTs***) or REITs. While this may seem to permit fund managers unfettered discretion to leverage the trust, there are market forces at play which act as a disciplining force. This disciplining force serves as an effective means of regulating how the deployment of financial resources are managed so as to ensure investors are adequately protected. Market determined gearing levels provide access to a wider range of capital and therefore improves the ability of a REIT to diversify its asset base. The market accepted gearing of an Australian LPT is about 50% to 60% of net asset value. Australian LPT trust deeds have generally assumed an upper limit on gearing of 60% even though there is no mandatory requirement for an upper limit. In practice, LPTs with Australian assets borrow in the region of 30% to 35% as this is the level that market forces have determined to be acceptable. The borrowings of cross border LPTs listed in Australia and investing mostly in US properties, average around 50% which is accepted by the market for various reasons including reducing withholding tax in the US. In Australia, there has also been a significant improvement and increased sophistication in LPT capital management practices, with managers using

hedge instruments, for example, to protect investors from adverse movements in interest rates and, in the case of offshore assets, foreign exchange rates. The capital management policy is disclosed in summary form in the annual reports of LPTs as well as the financial statements of LPTs providing investors with assurance as to the level of protection. It is common market practice for LPTs and REITs overseas to hedge floating interest rates and exchange rates, for approximately five years, as REITS are considered long term stable investments.

(2) Market practitioners have suggested that the Commission should consider allowing special product features, such as payment of management fees by way of issuance of units. These were made based on observations of the recent development in other major REIT markets. The Commission is prepared to consider, on a case-by-case basis, requests for incorporation of special features in a REIT subject to the overall principle that investor interest can be safeguarded. In this connection, what particular features do you think the Commission should consider in product applications?

Performance fee structure
In other jurisdictions the basis of performance fees for REIT managers, which seek to incentivise the manager and align interests, may be linked to increases in the share price, net asset growth, income growth as well as relative share price outperformance.

The Regulation of Asset Managers (Type 9) in Hong Kong and the REIT Code limit the basis of performance fees to being based solely on net asset value. This alone may not be the best measure of performance of a fund manager and could impact on the ability of the manager to align interests with investors and place HK REITs at a disadvantage to REITs based in other jurisdictions. We recommend that the regulations be relaxed to allow for more flexibility in designing and adopting the basis of performance fee arrangements for a REIT.

Payment of management fees in units
The ability of the manager to be issued with units in lieu of fees is a product feature available in other jurisdictions. We would support its introduction in Hong Kong. Such a feature may provide further benefits to investors from a funding perspective and increase alignment of interests between the fund manager and the investors.

REIT structuring
While not mentioned in the Consultation Paper, the proposed changes must be accompanied by allowing more layers of corporate special purpose vehicles (***SPVs***) to be included within the REIT structure. We recommend restrictions on the number of corporate levels (currently only two are allowed) be removed completely. The current restriction could inhibit the creation of cross borders REITs by making it difficult to structure investments efficiently for tax purposes.

It is possible, in order to optimise the structuring of cross border REITs, that an interest in properties may be sought to be held through co-mingled funds or debt or derivative instruments. In recognition of this, the SFC should consider allowing for special approvals or waiver of the REIT Code where the REIT manager can demonstrate the commercial rationale for the proposed structuring and outline how the risks associated are adequately addressed.

SPV ownership levels
The restriction which requires that SPVs be 100% controlled or owned by the REIT should also be relaxed in order to allow efficient structuring of offshore vehicles. For instance, in some jurisdictions it may be appropriate to have dispersion of investors to obtain a more favourable tax treatment. In addition, it is not possible for the REIT to own 100% of the SPV in some countries (e.g. Malaysia), therefore the enforcement of the 100% provision may restrict the REITs' ability to invest in certain locations.

Two year restriction on sale of properties
Currently there is a restriction on the sale of properties within two years. This could be detrimental to investors and should be relaxed to, as a minimum, allow sale of properties below a materiality threshold (such as 10% of gross asset value) at any time.

Partly paid structures
We understand that partly paid IPO structures are currently not allowed under the Listing Rules for companies seeking a listing in HK. However REITs could benefit from partly paid IPO structures under circumstances where there are deferred elements to capital requirements or where the rental income of certain properties at the time of IPO has not yet stabilised. It would be more beneficial for investors to be able to contribute equity as and when capital is required, or when the income potential of a property is fully realised. Similarly, partly paid structures for secondary capital raisings would allow REITs to commit to acquiring assets without having to earn returns on new investor capital until the capital is deployed. This would allow REITs to reduce the transaction risk associated with acquiring new assets and ensure existing capital is not diluted while transactions are completed.

(3) Should the REIT application fee be levied on a cost recovery basis?

The level of fees incurred in relation to REIT applications should be clear and able to be understood with certainty. We recommend a fee structure with fixed and scalable components. The fixed component of the fee could allow for cost recovery for the most basic application to the SFC at a minimum level, while the prescribed scalable component of the fee (as a function of assets under management and/or number of jurisdictions covered), could account for increased costs associated with larger applications. This proposed structure should provide the SFC with cost recovery and market participants with expense certainty.

(4) Do you have any views on whether the management company could/should take out professional indemnity insurance and title insurance?

Management companies should have professional indemnity insurance cover, but this cover should specifically be able to be held under a group professional indemnity policy.

Title insurance should not be mandatory and should be subject to the manager's discretion and disclosure.

The determination by the manager of whether to buy title insurance should be subject to cost and availability as well as market practice and title risk. The cost and adequacy of cover may differ widely across sectors, countries and properties. Furthermore, The existence of title insurance may not necessarily and totally protect investors' capital. Some investors may place over reliance on the title insurance.

A mandatory requirement for title insurance could lead to HK REITs being non-competitive as buyers of property in jurisdictions where title insurance is not generally available or is not a requirement for other buyers.

(5) Other – Principal Valuer

Maintaining a principal valuer for the entire portfolio attains consistency but does not provide investors with differing market views and cost efficiency. Consistency in valuation approach and reports can be achieved by the manager and trustee using detailed and clear instruction letters to the valuer and also by using internationally recognised valuers who will have some level of consistency to approach and methods.

All properties are different and all countries may be different. Certain valuation firms will have expertise in one or more sectors and one or more countries, however, they will not always be active in all sectors and all countries. A single valuer over the entire portfolio, may mean that a HK REIT could miss the opportunity to use the best or most appropriate valuer in a sector and/or a country.

Having the principal valuer appoint valuers in overseas countries, should the principal valuer not have the appropriate expertise itself, removes control from the REIT manager and may result in an outcome that is not in the best interests of investors. The use of a principal valuer will restrict HK REITs and subject HK REITs to higher costs as the principal valuer will have no competition, nor incentive to provide competitive rates, thereby providing no real benefits to investors.

We understand that other REIT markets such as Australia and the US do not have the "principal valuer" concept with the power to appoint valuers placed at the discretion of the management company and governed by the compliance regime and market practices.

Proper instructions and scrutiny from investors of the REIT disclosures will pressure the manager to act in the interests of the investors by using appropriate valuers and ensuring high quality of reports.

B. Comments on "APPENDIX 1- DRAFT PRACTICE NOTE ON OVERSEAS INVESTMENTS"

General Comment

The initiatives proposed by the SFC towards more of a risk disclosure basis, enabling the market to determine how REIT's develop in HK is supported by Macquarie Group.

Some of the steps proposed to be performed in due diligence or disclosed to investors (S38/S24(3)) could, however, be viewed as being overly prescriptive. Consideration should be given to revising these to allow the manager to take account of materiality, the relevance or applicability of all these points and to enable the aggregation or pooling individual properties.

The concern is that some of the required disclosures may prove to be too onerous and costly and detract from the development of the HK REIT market. Over disclosure can also mean investors become overloaded with massive quantities of information which may detract from the relevant or important disclosures.

Further guidance or allowance should be given on the application of materiality. For example, we would not expect that the level of disclosure or due diligence required for the acquisition of a $1 million property would be identical to that for a $500 million property.

The following numbers correspond to the specific paragraphs in the Draft Practice Note.

S2 - Consideration should be given to highlighting the importance of property investment and asset management experience gained from managing external funds invested in property. Experience in property portfolio management alone would not tend to be viewed as sufficient to assess the relevant experience for a proposed REIT manager. Experience in compliance, regulations and investor reporting should be taken into consideration together with experience in property portfolio management in assessing the suitably of a proposed REIT manager.

S9 – Suggest that the SFC's interpretation of "firm support from the group of which the management company is a member" be clarified. Certain jurisdictions do not allow financial institutions to in any way support the activities of its funds management subsidiaries. That said, documented arrangements, on commercial terms and at arm's length basis are implemented to allow provision of resources (staff, offices etc) to enable the funds management subsidiary to perform its tasks. Flexibility with the interpretation of "support" will enable global business operators to comply with HK and other jurisdictional regulatory requirements.

S10 - The business plan submitted to the SFC detailing how the investment strategy will be implemented would cover short to medium term plans for the REIT. The SFC could clarify that the business plan is a pre-listing requirement. After listing, major changes to plans and strategies would assumedly involve disclosure and shareholder approval, where appropriate.

S11 - Apart from the management "company", account should be taken of the track record, systems and controls of the group. The management company is likely to be a new entity whose operations would only commence on REIT listing. The wording of section 11 may hence be amended to reflect the lack of track record or established systems and controls in the company.

S14 - Restricting the size of a REIT that could be managed by the management company may be detrimental to the interests of investors and the REIT manager. Such restrictions are likely to detract from the attractiveness of a REIT investment and the potential for future capital growth. Further clarity on the mechanisms proposed to restrict the size of REITS is warranted. Any restriction which required a forced liquidation of assets where asset values increase above a certain size could create negative consequences. Restricting growth may make it less attractive to establish a cross border REIT in HK.

To achieve growth of a material nature, REITs require the support of investors due to restrictions on their ability to raise capital without unitholders' approval. As a result, the growth of a REIT will be determined by market forces. Investors will scrutinise future acquisitions that they are being asked to fund and will not support transactions that are potentially detrimental to the overall quality of the portfolio and the earnings profile of the REIT.

It may be appropriate to delete this restriction from the code.

S16 - Compliance plans are widely utilised in other jurisdictions such as Australia. We support the SFC's initiative but recommend that the emphasis be placed on the compliance framework developed which is appropriate going forward. Compliance plans tend not to deal with every contingency that may arise and therefore we expect the initial contingency planning would only be high level.

S17(1) - Where an overseas entity is a group or related party the same level of due diligence to ensure such overseas entity is competent should not be required.

S17(3) – Suggest that the definition of "material matters" be clarified.

Macquarie Group's usual business operations, which is comparable to general market practice in Australia generally, allows the property manager to be responsible for matters within the following scope:

- Employment of personnel for the property management company
- Preparation of an annual budget (but submitted to the management company for approval)
- Collection of monies from rent, car parks, advertising space, licensing fees and other ancillary income
- Maintenance of office records, books and accounts
- Maintenance and repair of property and associated plant and equipment (air-conditioning, fire protection, lift services, common area, cleaning, traffic control, etc)
- Providing relevant reports to the management company (comparison to budget, capital expenditure, leasing status, audit of property, annual statements)
- Compliance with relevant legal requirements
- Ordering such equipment, tools, appliances, materials and supplies to properly maintain the properties
- Maintaining current insurance over property (public liability, fire, crime, etc), although the insurance premiums will be paid by management company
- Investigating incidents, accidents and claims relating to the property and provide reports to the management company
- Providing assistance to tenants
- Reviewing tenant premises and coordinating and monitoring improvement works
- Identifying potential tenants
- Providing assistance with determining the market value of property
- Cooperating with the management company during any sale or transfer of property

Decisions relating to these matters will be made by the property manager.

Decisions as to the appropriateness of the financial budget for the property, when the property will be valued, whether the property should be sold or transferred, will typically be made by the management company.

S18 – It may be difficult for the management company to identify conflicts of interest in relation to the overseas entity, particularly where confidential business dealings and personal relationships may not be publicly available. Suggest that this requirement may be clarified further by specifying that an undertaking from the overseas entity

to disclose to the board of the management company any conflicts of interest will be a sufficient process to identify conflicts.

S19 – Is it anticipated that the documented due diligence procedures, processes and decisions be provided to the SFC as part of the application process? We suggest that these form part of the management company's internal records, available for inspection by the SFC as part of its regulatory role.

S19(1) - The management company should "reasonably" ensure that this is the case and should be able to place reliance on third parties.

S19 (2) - Title insurance should not be a mandatory requirement. Apart from cost and availability, market practice and risk should also be considered. In many countries title insurance is not generally obtained because the system for registration of title is so well developed that the market does not require title insurance. In other countries, where the system of registration of title is less developed, it may not be possible to take out title insurance as such product or service is not provided by any one. Making title insurance mandatory could make it impossible for HK REITs to invest in such markets**.**

S25 – Note 3- we suggest that guidelines note the level of detail required when disclosing these matters, so as to meet the requirements of fair, accurate and clear disclosure. Clear and proper disclosure should take into account the needs of the varying levels of sophistication of investors, ensuring that information provided is simple and easy to understand. Suggest that the SFC provide guidance that overly complex and detailed information not be included in disclosure to investors.

S30 - Suggest "All" be removed as it could become very restrictive. A trustee's role in safeguarding the interests of investors with respect to their involvement in a REIT's activities, should take account of materiality. Trustees should be able to nominate delegated authorities to third parties for responsibility in relation to executing agreements.

For example a trustee should not be expected to sign every lease in a diverse property portfolio. This is not market practice in other countries and would be even more impractical for an offshore managed property portfolio.

Amending the requirement that "all" agreements be verified to "material" would enable the trustee relationship to operate more efficiently.

S31 - The SFC may like to consider amending the principal valuer appointment to only being required to apply to valuations supporting material transactions.

The cost and efficiency of involving multiple valuers in differing jurisdictions may make this unattractive where valuations have to be performed on a regular annual basis for accounting and disclosure purposes.

S33- It should be noted that in other jurisdictions the manager and trustee are responsible for appointing valuers and this is not outsourced to another appointee.

S38 – We suggest that a broad and clear explanation of each item in this section (rather than detailed descriptions) will be sufficient to enable investors of varying levels of sophistication to understand the particular investment.

We would normally expect that all this information would necessarily be required to be detailed, particularly internal controls. Requiring detailed information on all matters may detract from the more significant matters. In other jurisdictions, regulators have been able to be satisfied with summarised disclosures. Reducing the level of detailed disclosures, introducing the concept of materiality, allowing properties to be pooled/aggregated into groups and placing reliance on the requirement that the manager disclose any material matters would be recommended.

S38(k) -The SFC may like to revise this section to focus on factors or risks which may impact or act as an impediment to an exit from the properties.

As a long term holder of property, reporting an exit strategy is more a theoretical exercise. REITs will tend to look to invest in long term stable investments, therefore, making references to exit strategies is inconsistent with this and also with the two year restriction on selling properties.

S39 - With the exception of the following matter, we suggest that a broad and clear explanation of each item in this section (rather than detailed descriptions) will be sufficient to enable investors of varying levels of sophistication to understand the particular investment:

(a) Critical assessment of valuer assumptions.

S40 – We support the disclosure of arrangements entered into for the REIT to own the title to the property, but suggest that a discussion of the benefits and drawbacks of such an arrangement may not be meaningful to investors.

S41 - We suggest that a broad and clear explanation of each item in paragraphs (b) and (c) will be sufficient to enable investors of varying levels of sophistication to understand the due diligence and delegation processes.

Should have any queries regarding our submission please kindly contact our Compliance Director, Mr. Simon Ng at (852) 2823-3785.

Yours faithfully,

Simon Ng
Compliance Director