THE LAW SOCIETY OF HONG KONG 香港律師會

Comments on Consultation Paper on Draft Practice Note on Overseas Investments by SFC Authorised Real Estate Investment Trusts (Practice Note)

The Law Society's Securities Law Committee ("Committee") is of the view that permitting SFC authorised Real Estate Investment Trusts (**REITs**) to make overseas investments will make Hong Kong regulation of REITs more consistent with the regulation of REITs in other markets. REITs in most jurisdictions do not have geographical limitations on investments. However, the Committee is of the view that some of the specific proposals in the draft practice note are both unrealistic and unreasonable (in particular some of the burdens imposed on the management company is unduly onerous) as well as being unclear and being open to subjective interpretations.

Comments on specific proposals contained in the draft Practice Note are set out below (following the numbering of the draft Practice Note).

A. PROPOSALS FOR REGULATING OVERSEAS INVESTMENTS BY REITS

Management Company

9. The requirement for "firm support" from the group of which a management company is a member should be deleted. This is not required if other fund managers and the Committee sees no reason why support should be imposed on managers of REITs when it is not a general requirement for all intermediaries regulated by the SFC. In any event the phrase "firm support" is vague and unclear.

10. This paragraph assumes that "certain risks" can be mitigated "if a management company has proper measures in place". It is implicit in this statement that there is an expectation that certain unspecified risks can be mitigated and that if they are not mitigated then this means that the management company is not doing its job properly. The Committee is of the view that this approach is misguided and imposes a burden on the management company which is both uncertain and unrealistic. The Committee is of the view that the management company's obligations with respect to risk should be to take all reasonable steps to identify risks associated with its overseas investments and take appropriate steps to manage those risks when it is both practical, possible and cost effective to do so and to make appropriate disclosure of those risks in the offering document.

13. The Committee does not agree with the proposal that in licensing a management company as a REIT manager which invests in overseas properties, the Commission will generally only allow it to manage one REIT. The Committee is of the view that managers of REITs should not be prohibited from managing more than one REIT (provided the manager has sufficient qualifications and experience in managing real estate in each relevant market). In this respect, the Committee sees no reason why managers of REITs should be treated any differently from the managers of other collective investment schemes. Conflict of interest is obviously an issue that would need to be addressed but, in this respect, managers of REITs are no different from other fund managers and financial intermediaries generally.

14. The Committee has concerns about the proposals to restrict the business of a manager of a REIT. While this may be appropriate for a management company which is owned within a

REIT, the Committee sees no reason why managers of REITs should have restrictions placed on their business activities generally. In addition, the Committee notes that such restrictions are not imposed on intermediaries licensed to manage assets other than real estate.

15. See comments on 14.

19. Note (1) states that the management company shall ensure that the rights of a REIT "are enforceable in the judicial system" of a relevant overseas jurisdiction. The Committee is of the view that this is impossible as a matter of general legal principles. Whether a legal right is enforceable is generally dependent on the ability to apply to court for an order granting enforcement. In most jurisdictions (including Hong Kong) the award of court orders is a matter for the court's discretion.

Note (7) should be redrafted as follows:

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

25. The words "… the REIT has ownership of more than 50% in the property …" should be changed to "… the REIT has ownership of at least 50% in each property …". Fifty-fifty joint ventures should be permitted.

25(b) Legal opinions of this nature will be subject to the usual qualifications and assumptions of opinions given in each relevant jurisdiction. Also, the provision should provide for multiple opinions to be given as there may well be circumstances where a single opinion is impracticable.

32. It is not clear what is meant by the Principal Valuer's obligation to "certify" the valuation prepared by an overseas valuer.

B. PROPOSALS FOR COMPETENCE REQUIREMENTS OF REIT MANAGERS

The Committee agrees with the view that a property portfolio manager who also possesses in-house relevant investment management expertise is a suitable candidate to be a REIT manager, so long as he demonstrates that he is fit and proper and satisfies all relevant criteria for obtaining a licence.

C. COMMENTS FROM THE PUBLIC

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 REIT Code?

The Committee has no view as on this issue – the level of gearing is a commercial matter – so long as adequate disclosure is made to investors.

2. 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?

The Committee is of the view that internal management structures should be expressly provided for.

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

The Committee has no views on this.

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

The Committee is neutral as to whether it is desirable for the management company to take out professional indemnity insurance.

With respect to title insurance, the Committee is of the view that it is unnecessary for several reasons. First, if such insurance is not required for Hong Kong properties, there is no strong reason that it should be required for overseas properties. Second, as comparable insurance is not required for other types of overseas investments, such as an investment in shares of listed companies which invest in overseas properties, there is no particular reason that REITs require more protection. Third, the proposal that the management company should take out title insurance if this is generally available at reasonable costs will increase the costs of the REIT in investing in places where title insurance is available and encourage the management company to invest in countries without title insurance where it is likely that the risk of investing in properties is higher. The Committee is on the view that the provisions contained in the Practice Note as to the due diligence required with respect to the ownership and legal title of the property, combined with a legal opinion on the same and the risk disclosure requirements in the offering document and circular are likely to be sufficient to meet the objective of protecting investors from risk from defects in title.

The Committee views the questions of professional indemnity insurance and title insurance as being commercial decisions for the management company to make, subject to proper disclosure being made.

The Law Society of Hong Kong
The Securities Law Committee
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