BY HAND & BY FAX

May 17, 2005

Investment Products Department
The Securities and Futures Commission
8th Floor, Chater House
Hong Kong

Dear Sirs,

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

We write to provide comments on the Consultation Paper on Draft Practice Note on Overseas Investments by SFC-Authorized Real Estate Investment Trusts ("Consultation Paper").

I) Allowing REITs to invest in overseas properties

We welcome the proposed practice note ("Practice Note") on overseas investments and we agree that such relaxation for the Real Estate Investment Trusts ("REITs") to invest in foreign properties should be implemented as soon as possible. The relaxation would bring the Code on Real Estate Investment Trusts ("REIT Code") into line with the practices in other jurisdictions around the world, particularly Singapore.

We also agree with The Securities and Futures Commission ("SFC") to specify the general responsibilities and expectations on a management company on its decision to make overseas investments on behalf of a scheme. The monitoring of the management company through additional due diligence and disclosure for overseas investments should be adequate for protecting investors' interest.

We believe that the risks associated with overseas investments cannot be mitigated completely. However, with proper disclosure, investors should make their own investment decisions knowing the associated risks involved. We believe the risk differential would be reflected in the trading prices (or valuation) of the REITs that hold overseas properties. This, in fact, is beneficial to the market as a whole as investors will have access to investments that offer different returns with different risk profiles.

Investors are generally accustomed to investing in non-REIT listed entities in Hong Kong that invest in overseas properties with much less information than those being proposed in the Practice Note. The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited ("Listing Rules") have never restricted investment activities by listed companies in overseas assets. Similar to what is being proposed in the Practice Note, the Listing Rules have only set out guidelines for

Citigroup Global Markets Asia Limited 50th Floor Citibank Tower, Citibank Plaza, 3 Garden Road, Central, Hong Kong Tel 852 2501 2000 Fax 852 2501 8146

disclosure and have placed the responsibilities on the directors of the listed companies through various provisions in the Listing Rules and model codes.

Lastly, we agree that all REITs in Hong Kong should be regulated by the same regime, i.e. the REIT Code. This would ensure consistency and uniformity in monitoring REITs listed in Hong Kong. The use of the Practice Note to supplement the REIT Code is appropriate because the same standard of care should be applied across all properties, though additional features need to be considered for foreign properties.

In allowing REITs to invest in foreign properties, we suggest the SFC also consider providing flexibility in the structuring of special purpose vehicles.

Foreign properties, including those in the PRC, are normally held through a series of special purpose vehicles for ease of transfer or through joint venture companies (e.g. sino-foreign joint ventures in China) for tax or regulatory purposes. If a REIT in Hong Kong invests in foreign properties, it is likely that the REIT would invest through at least two layers of companies, e.g. one local registered company and one foreign registered company such as a BVI registered company. Given that REITs normally employ a special purpose vehicle that is owned 100% by the scheme to hold all the scheme assets together, a three-layer structure could be created.

Under REIT Code 7.5, only two layers of special purpose vehicles are allowed. Such special purpose vehicles must also be 100% legally and beneficially owned by the scheme. With the relaxation of the REIT Code, we suggest that the SFC should consider relaxing such restriction. Otherwise, potential REIT issuers may find it difficult to transfer holdings in foreign properties into the scheme as the scheme would be required to own the interest in the local company that in turn owns the foreign properties. Such transfers can be very costly because of local tax regimes and also very time consuming because of required regulatory approvals.

II) Response to specific questions raised in the Consultation Paper

Question (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?

We are fully supportive of this proposal to give REITs more flexibility in determining their optimal capital structures. While more developed REIT markets do not impose gearing restrictions, Hong Kong, being a new market for REITs, could start off with a controlled level so that the market could build experience in structuring and investing into REITs.

As you will note from the following table, all well-developed markets, namely the US, Australia and Japan, do not impose a limit on gearing levels. Singapore, a rapidly

citigroup

developing market, has a cap at 35% with an embedded market-based exemption. The less-well developed markets, on the other hand, tend to have stricter requirements on gearing levels.

Country	No. of REITs	Market cap (US$)	Limitation on gearing level	Market average gearing level
US	210	292 billion	No restriction	55%
Australia	30	60 billion	No restriction	38%
Japan	16	8 billion	No restriction	25-45%
Singapore	5	5 billion	Gearing Cap <35% of deposited property unless debt rated A or above	27%
Malaysia	3	70 million	35% of assets, unless approved by Securities Commission	
Thailand	4	40 million	Borrowings not permitted	
South Korea	5	620 million	Borrowings not permitted	
Taiwan	1	190 million	Not stated, but regulators prefer less than 35% of gross asset value	

Source: Smith Barney Research Report (appended to this letter), Factset

The considerations on capital structures in the US, Australia and Japan could differ substantially from the ones in Hong Kong, such as the tax benefits, market depth and liquidity. However the average REIT gearing level of 25-55% in these countries give us grounds to believe the proposed increase in the gearing cap to 40-50% could give the necessary liberty and benefits for REITs in Hong Kong to gear up, if so desired, to bring their capital structures in line with an average REIT in the developed markets.

According to a report published by Moody's entitled " Key Ratios for Rating REITs and Other Property Firms", "there is a discernible correlation between the ratios and our ratings (e.g. lower leverage = higher ratings)". Moody's report also shows the median key financial ratios against ratings, which are reproduced in table 2 below:

Fixed Charge Coverage

	Property Firms (as of 9/30/04)	Industrial Firms (as of 12/31/03)
Rating	Median	Median
A	3.63	5.94
Baa	2.64	3.87
Ba	2.06	3.05
B	1.41	1.46

Total Debt / Total Assets

	Property Firms (as of 9/30/04)	Industrial Firms (as of 12/31/03)
Rating	Median	Median
A	38.60	25.70
Baa	42.75	28.66
Ba	50.89	32.58
B	42.04	46.87

Total Debt / EBITDA

	Property Firms (as of 9/30/04)	Industrial Firms (as of 12/31/03)
Rating	Median	Median
A	6.79	1.65
Baa	5.85	2.18
Ba	6.68	2.83
B	4.63	3.86

Source: Moody's 2004

In addition to the rating agencies, investors, banks, market commentators and research analysts would also actively monitor the gearing levels of REITs and trade accordingly. These market forces would serve the most effective check-and-balance for the REITs in determining their debt financing and capital structures.

It is also correctly pointed out in the Consultation Paper that the leverage on overseas investments provides a natural hedge against currency risk. Naturally speaking, the higher the leverage the greater the hedge. A low gearing ceiling may serve to increase risks facing REITs and force REITs to use standard derivative products, which might be less cost effective, to hedge currency risk. We understand from our Australian colleagues that, in Australia, REITs have tended to have higher leverage on overseas investments (typically 45-55%) than domestic Australian investments (typically 25-40%).

However, in raising the gearing limitation with a view of the possible overseas debt exposure, we encourage the SFC to carefully consider imposing adequate disclosure requirements so that investors would be provided with details of overseas debt and any legal or tax issues surrounding such overseas borrowings.

Question (2)

Special product features

We are pleased that the SFC is mindful of the importance of being flexible when approving special product features that may be used by REITs. These features typically would serve to improve the yield payable to unitholders, thereby bridging potential valuation gaps between sponsors and investors that sometimes prevent REITs from being formed. We would be delighted to separately discuss with the SFC other special product features that we believe would be beneficial for REITs in Hong Kong.

Question (3)

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

We believe it is reasonable that a REIT application fee could be levied on a cost recovery basis. Specifically, a reasonable fee based on market capitalization or asset value of a REIT would be justified given that larger REITs would generally require higher cost of vetting and monitoring.

The current flat fee charged by the SFC (HK$20,000) for initial listing of REITs is generous as compared with Singapore (S$10,000). However, the cost of setting up a REIT with local properties is much higher in Hong Kong than in Singapore. The Inland Revenue of Hong Kong levies up to 3.75% stamp duty for transfer of properties into a REIT, both at the time of IPO as well as subsequent to IPO. The Singapore Government, in its 2005 budget, removed the 3% stamp duty on purchase of properties by REITs for 5 years to 2010.

The initial listing fee and the annual listing fee are generally insignificant as compared to other costs involved. As such, issuers should accept a reasonable fee based on cost recovery that is in line with the cost in other markets.

Question (4)

Do you have any views on whether the management company could/should take out professional indemnity insurance and title insurance?
We believe professional indemnity insurance taken out by a management company could provide extra protection to investors who will have higher level of certainty of claiming compensation in case something went sour and caused by the ignorance or incompetence of the management company. In our view, there is little downside of taking out professional indemnity insurance, especially if the REIT is managed by an external management company and there is a lack of alignment of interest between the owner and the manager.

Taking out professional insurance is a protection for the managers of the management company. Many listed companies provide this protection to their directors and it is becoming very important to attract capable directors given the increased potential liabilities that directors may face. Although investors in Hong Kong rarely sue directors, the international status of the Hong Kong market has attracted huge investment funds from around the world, including those from the US. These investment funds are accustomed to the US legal system where directors are often held directly responsible for any faults in the company. Also, the codification of rules on corporate governance and director's responsibilities in Hong Kong and the enactment of the Securities and Futures Ordinance have placed increased pressure on directors. Professional insurance would alleviate certain psychological pressure on the directors resulting from the increased requirement on corporate governance. One may argue that taking out such insurance would render the directors less accountable to their responsibilities. We believe this would not be the case because the insurance normally would exclude action that is willfully committed. Also, the insurance could never mend the loss of personal reputation of directors who have breached their fiduciary duties to their shareholders.

Title insurance could provide a second layer of protection to investors in respect of perfection of title though the first layer of protection should rest with the expertise of management companies. If a management company believes there are risks involved in the title of properties, the management company should first decide whether to invest in the first place, not whether title insurance could mitigate the risk. If the management company is comfortable with the title, taking out title insurance becomes an added protection. Title insurance provides higher certainty to investors who rely solely on the judgment of the management company in conducting adequate due diligence. However, the insurance comes at a cost and therefore the management company needs to assess the costs and benefits of having such insurance, that provide certainty on matters that the management company should have a good handle on already.

We appreciate the opportunity to provide our comments in relation to the Consultation Paper. Please do not hesitate to contact the undersigned at (852) 2501 2082 should you wish to discuss our comments in further detail.

Yours faithfully,

Frank J. Slevin
Managing Director
Head of Corporate and
Investment Banking, Hong Kong

Edmund Ho
Director
Hong Kong Investment Banking