COMMENTS ON THE SFC'S CONSULTATION PAPER ON DRAFT PRACTICE NOTE ON OVERSEAS INVESTMENTS BY SFC-AUTHORISED REAL ESTATE INVESTMENT TRUSTS

We are pleased to submit our comments on the proposed Practice Note on Overseas Investments by SFC-Authorised Real Estate Investment Trusts (the "**Practice Note**").

The lifting of the restrictions on overseas investments by real estate investment trusts ("**REITs**") authorised by the SFC under the Code on REITs is a positive step for the Hong Kong market. We commend the SFC on its thorough efforts, and its openness in consulting with the market, in reviewing the relevant issues relating to overseas property investments by REITs and in preparing the detailed draft Practice Note.

A. COMMENTS ON THE SPECIFIC ISSUES RAISED BY THE SFC

1. Gearing limit

The SFC has asked whether the limit on the gearing ratio for SFC-authorised REITs should be increased beyond the current limit of 35%. We support the proposal to increase the limit on the gearing ratio for SFC-authorised REITs, as a higher limit will provide more flexibility to market participants in structuring REITs and REIT-related transactions.

2. Special Product Features

The SFC should consider allowing the following two features that are commonly found in REITs in other comparable markets:

(a) Payment of management fees by way of issuance of units. This feature aligns the interests of the management company with the interests of the unit-holders. Therefore, it is beneficial to the unit-holders. Given the strict requirements in Chapter 8 of the Code on REITs, unit-holders' interests should be sufficiently safeguarded.

(b) Payment of acquisition and divestment fees to the management company in connection with the acquisition or sale of properties by the REIT. In many instances for REITs operating in other comparable markets, such acquisition and divestment fees are calculated as a percentage of the value of the properties to be acquired or divested (as the case may be). Currently, such percentage-based transaction fees payable to the management company may be disallowed under the Code on REITs (see the Note to paragraph 9.10 of the Code on REITs), on the basis that they are inconsistent with the management company's fiduciary responsibility. We believe that the SFC should consider permitting payment of such acquisition and divestment fees to the management company, whether in cash or in units of the REIT, for the following reasons:

(i) Payment of such acquisition and divestment fees to the management company is permitted in other competing jurisdictions, such as Australia and Singapore. If the rules in Hong Kong were to disallow the payment of such fees, it would put Hong Kong out of line with the accepted market practices in this region.

(ii) We note that acquisition fees and divestment fees calculated as a percentage of the value of the properties to be acquired or sold are permitted by the regulators in Singapore. Provided that full disclosure of the management company's right to charge such fees is made in the offering document of the REIT, and the acquisition or divestment is in the interests of the REIT (for example, if the acquisition is yield-accretive to the REIT, or the disposal would, in the judgment of the management company, enable the REIT to take advantage of favourable market valuation), payment of such fees is not generally regarded as being inconsistent with the management company's fiduciary obligations to the REIT.

The SFC may, however, wish to consider whether the calculation of the acquisition and divestment fees based on the value of the properties acquired or sold is appropriate, or whether the fees should be calculated on some other appropriate basis that reflects the value of the management company's contribution.

(iii) Investors' interests should be protected, as most acquisitions and disposals of properties by the REIT would, under the Code on REIT, require a circular to be issued to the unit-holders. Where the acquisition is to be financed by way of a further issuance of units, in most instances, approval of unit-holders will also be required. The management company will be required to explain to the unit-holders in such circular the reasonableness and fairness of the proposed transaction. Unit-holders who disagree with the proposed transaction will have the opportunity to either dispose of their units on the market, or to vote against the fund raising.

3. Professional indemnity insurance

Note (3) to paragraph 19 of the draft Practice Note states that, when investing in overseas properties, the management company shall ensure that its investment management activities in relation to overseas investments are covered by its professional indemnity insurance. We suggest that the SFC delete this requirement from the Practice Note, for the following reasons:

(a) Currently, under the Securities and Futures (Insurance) Rules, the holder of a Type 9 licence who is not an exchange participant of The Stock Exchange of Hong Kong Limited, and whose licence is subject to the condition that it shall not hold client assets, is not required to maintain insurance under the rules. As far as we are aware, there are no other mandatory requirements for a fund manager to maintain professional indemnity insurance.

(b) Such requirement to take out professional indemnity insurance would increase the operating costs of a REIT manager.

(c) Under the Code on REITs, the management company of a REIT that invests only in Hong Kong properties is not required to take out professional indemnity insurance. The requirement under Note (3) to paragraph 19 of the draft Practice Note, if applicable only to those management companies that manage REITs investing overseas, would create an uneven playing field between such management companies and those that manage REITs that invest only in Hong Kong properties.

(d) The extensive due diligence, disclosure and other prudential requirements in the Practice Note already provide substantial protection of the interests of unit-holders of a REIT that invests overseas.

If the SFC is nevertheless minded to impose this requirement, we believe that this requirement would only be meaningful if the minimum amount of the professional indemnity insurance coverage is specified (whether in the Practice Note or in some other circulars or guidelines from the SFC). The industry should be consulted on the appropriate threshold for the professional indemnity insurance coverage before it is fixed.

4. Title insurance

Note (2) to paragraph 19 of the draft Practice Note states that the management company shall endeavour to take out title insurance for overseas properties (where such insurance is generally available) at reasonable costs. We submit that this requirement is onerous and impracticable, for the following reasons:

(a) The general consensus of the market is that many of the overseas properties to be injected into SFC-authorised REITs are likely to be located in the People's Republic of China ("**PRC**"). We understand that title insurance may not be generally available in the market in the PRC. Although Note (2) to paragraph 19 is qualified by the statements "where such insurance is generally available" and "at reasonable costs", the presence of this note will put the management company and the trustee in the difficult position of having to show that sufficient attempts have been made to obtain the title insurance. Even if a quotation is obtained by the management company for such title insurance, it could be difficult for the management company and the trustee to form a judgment as to whether the costs for the title insurance are reasonable as there is likely to be a lack of a market benchmark. In addition, it is possible that coverage under the title insurance may be subject to various carve-outs for potential title defects or risks identified by or disclosed to the insurer. In such event, it could be difficult for the management company and the trustee to form a judgment on whether the costs of the title insurance is justified in view of the risks that are excluded from coverage under the insurance.

(b) The Code on REITs already contains a requirement that the REIT shall hold good marketable legal and beneficial title in all its real estate, whether directly or via a 100% owned special purpose vehicle (paragraph 7.7 of the Code on REITs). This requirement is emphasised in the Practice Note (at paragraph 25(b) thereof), which requires a legal opinion to be obtained with respect to the title ownership of the property to be acquired by the REIT. In addition, the title to the property to be acquired by the REIT is normally covered by warranties and indemnities given by the sponsor or the vendor in the acquisition agreement relating to the property. It is submitted that the requirement for title insurance in the face of these existing safeguards regarding title of the property would create an unnecessary additional cost burden to the REIT.

(c) There is no requirement for a listed property company that invest in overseas property to take out title insurance on its overseas properties. Moreover, SFC-authorised REITs would (under the Practice Note) be subject to very specific and detailed due diligence obligations in respect of (among other things) ownership and legal title of the relevant property. Listed property company are not generally subject to such specific due diligence requirements. Imposing a title insurance requirement on REITs that invest in overseas properties would create an uneven playing field between REITs and listed property companies.

B. COMMENTS ON OTHER ISSUES IN THE CONSULTATION PAPER AND THE DRAFT PRACTICE NOTE

1. Competence requirements of REIT managers

The Consultation Paper states that the SFC will "directly recognise property portfolio management experience as being a core competency", and that the SFC is prepared "to directly accept a property portfolio manager as a REIT manager provided that it also possesses in-house relevant investment management expertise."

Could the SFC please clarify whether the requirements under Paragraph 5.4 of the Code on REIT, that the management company of a REIT shall have at least two responsible officers each of whom shall have *at least five years' track record in managing collective investment schemes (or in managing private funds)*, must still be complied with, if the management company can show that it has the in-house relevant investment management expertise.

2. Trustee to verify authenticity of documents

Paragraph 30 of the draft Practice Note requires the trustee to make reasonable endeavours to verify the legality and authenticity of all agreements in relation to a REIT, including title deeds and documents, property contracts, rental agreements, etc.

It is submitted that the requirement for the trustee to make reasonable endeavours to verify the authenticity of all agreements in relation to the REIT is too onerous and

should be deleted from the Practice Note. We note that most trust deeds of unit trusts specifically contain exclusion of liability in favour of the trustee in respect of the authenticity of any documents of title. The presence of this requirement to verify the authenticity of documents is likely to lead to the trustee seeking confirmations from its professional advisers (such as lawyers) as to the authenticity of agreements and documents of title relating to the REIT. In many cases, such professionals would be in no better position than the trustee to verify the authenticity of the documents, as the authenticity of a document is a question of fact. Furthermore, it is generally not possible for these advisers to verify the authenticity of a document after the fact (i.e. after its execution).

Deleting the requirement that the trustee shall make reasonable endeavours to verify the authenticity of all agreements and documents of title in relation to the REIT would not necessarily significantly increase investor risk for unit-holders. Under common law, the trustee must still exercise a level of care, skill, diligence and prudence that may reasonably be expected of a prudent trustee acting in a similar capacity. Therefore, should the trustee have notice of any matter that brings the authenticity of a document into question, the trustee would have a duty to investigate the matter. However, as drafted, Paragraph 30 of the Practice Notice could be read to suggest that the trustee has a positive obligation to underwrite the authenticity of all agreements and documents of title of the REIT.

3. Scope of the Practice Note

We note that the last sentence of paragraph 34 of the Practice Note states that the enhanced disclosure requirements set forth in paragraphs 35 to 42 of the Practice Note shall also be applicable to disclosure in relation to Hong Kong properties, *with appropriate modification*. In addition, it is stated on page 5 of the Consultation Paper that the draft Practice Note is applicable to all REITs, *where appropriate*, and not just those that invest in overseas properties. These provisions could lead to uncertainty as to which provisions in the Practice Note are also applicable to REITs that do not invest in overseas properties.

We suggest that the SFC revises the Code on REITs to incorporate specifically such matters covered in the draft Practice Note as should, in the SFC's view, also be applicable to REITs that invest only in Hong Kong properties, and to restrict the scope of the Practice Note only to REITs that invest in overseas properties. This would facilitate consistent interpretation and application of the Code on REITs and the Practice Note by market practitioners.

* * *

If the SFC would like to discuss or clarify any of our comments, please do not hesitate to contact our Milton Cheng at telephone number 2846 1056, or Cheung Yuk Tong at telephone number 2846 1916, or Jason Ng at 2846 2443.

Baker & McKenzie
30 April 2005