Submission to the Securities and Futures Commission in response to the Consultation Paper on Draft Practice Note on Overseas Investments by SFC-Authorised Real Estate Investment Trusts

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1 Introduction

1.1 Mallesons Stephen Jaques ("**Mallesons**") is pleased to make a submission in respect of the "*Consultation Paper on Draft Practice Note on Overseas Investments by SFC-Authorised Real Estate Investment Trusts*" (the "**Consultation Paper**").

1.2 This document is structured as follows:

(a) section two contains our Executive Summary;

(b) section three sets out Mallesons' comments in response to the SFC's questions raised in the Consultation Paper; and

(c) section four sets out Mallesons' comments on other matters in the draft Practice Note.

1.3 Terms not otherwise defined in this submission have the same meaning as in the Consultation Paper.

2 Executive Summary

2.1 Mallesons supports the proposal outlined by the SFC in its Consultation Paper for relaxing the restrictions on SFC-authorised REITs from investing overseas. While we comment on certain specific points of detail, we believe the broad thrust of the Consultation Paper is commendable.

2.2 In our view, amending the Code to allow Hong Kong authorised REITs to invest overseas:

(a) is consistent with Hong Kong being an international finance centre; and

(b) will, appropriately, allow the Hong Kong investing public greater diversity in the type of investments they may invest in.

2.3 In general, we submit that the REIT Code should:

(a) focus on ensuring that REIT mangers meet appropriate competency standards; and

(b) require full disclose to investors of risks and place appropriate obligations on managers, where commercially feasible, to manage those risks.

Based upon the above, we do not support prescriptive requirements on what a REIT may or may not do. However, given the developing nature of the Hong Kong REIT market, we consider that it may be appropriate for the Practice Note to contain prescriptive disclosure requirements.

2.4 Based upon the above paragraphs, in respect of the specific questions raised in the Consultation Paper, we submit as follows:

(a) Question 1: We submit that the gearing ratio should be increased to 50%.

(b) Question 2: We submit that a REIT should be permitted to incorporate special features, in particular, a REIT should be permitted to pay management fees in units.

(c) Question 3: We submit that the application fee for the authorisation of a REIT should be a fixed fee based on the costs incurred by the SFC in processing the application based on international best practice.

(d) Question 4: The taking out of insurance should not be a matter prescribed by the code, rather, it should be a matter subject to disclose in the offering circular.

3 Specific comments on the Consultation Paper

3.1 **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 consider that generally the REIT Code should focus on disclosure to investors rather than setting prescriptive requirements. On this basis, we submit that the REIT Code should impose a high gearing cap and contain a requirement for:

(a) the trust deed to set out a gearing policy; and

(b) for the manager to disclose the gearing policy in the REIT's offering circular.

3.2 **Question 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?

We support the REIT Code providing for flexibility in product features. We consider that, based on international experience, the key feature that the SFC should allow is for management fees to be paid as units in the REIT. This

enables the REIT and the manager greater flexibility in the management of cash flow. In additional, the holding of units by the manager will assist in ensuring that the manager's interest is aligned with the REIT's interest.

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

We support a fixed cost based prescribed application fee for the authorisation of a REIT. However, the fee should be based on the costs of international best practice.

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

We consider that it is important that the manager of a REIT:

(a) through due diligence identifies risks and then discloses those risks in the offering documentation; and

(b) implements, where appropriate, means to manage risks.

We submit that the REIT Code should not be prescriptive about what risks are managed or how they should be managed. We consider that the key is that the manager assess the risks and then develops polices to manage the identified risks. In respect of title risks, a range of factors will impact the nature of this risk such as:

(c) the jurisdiction in which the property is located;

(d) how the property was acquired; and

(e) the level of due diligence that was able to be conducted on the property.

The above risks need to be balanced against the costs of obtaining title insurance. This is a matter for expert judgement on a case by case basis.

4 Specific comments

4.1 Introduction

In this section, we comment on aspects of the draft Practice Note not covered by the specific questions above.

In general, consistent with international markets such as Australia, we submit that the REIT Code should focus on disclosure requirements rather than prescribing the structure of REITs or specific risk mitigation tools. The SFC's regulatory oversight should be focussed on ensuring that managers meet the required competency standard and that the manager fulfils its disclosure obligations.

4.2 Paragraph 5

We consider that the principles in this paragraph should be altered. This paragraph states that REIT operators "*are responsible for applying appropriate means and safeguards to mitigate foreign investment risks as much as practicable.*" We consider that the obligation should be to mitigate these risks as much as **commercially viable**. That is, a REIT operator needs to make a judgment about whether the costs of taking mitigating action are commercially viable given the nature of, and the probability of, the risk.

4.3 Paragraph 9

This paragraph states that where applicable "*there should be firm support from the group of which the management company is a member*". We submit that this needs to be clarified to address:

(a) what is meant by "where applicable";

(b) what is meant by "firm support". Is this intended to cover the provision of services through a documented services agreement or is it intended to require the provision of financial support?;

(c) If the paragraph is intended to require the provision of financial support, it should only apply to the extent that a parent company is permitted to provide such support under laws and regulations that govern the parent company. Moreover, the level of this support should be specified.

4.4 Paragraph 14

We understand the rationale for imposing a limit on the maximum size of a REIT that a management company may manage. However, in practice this may cause difficulties, in particular, where a REIT increases in size, whether through re-valuation or otherwise. If a licensing condition is imposed on a manager regarding the size of the REIT it may manage, it may breach its licence in the above circumstances. This seems to be an unreasonable outcome.

4.5 Paragraph 21

This paragraph requires the listing agent and the financial adviser to a REIT to conduct their own independent due diligence on the subject properties.

We submit that this needs to be clarified. In a company listing, the sponsor and the corporate adviser would normally review the due diligence undertaken by the applicant rather than conducting their own due diligence. In the context of a REIT, we would expect the REIT, through its manager, to appoint lawyers and other advisers to undertake due diligence. We would expect the trustee, the listing agent and the financial adviser to review the due diligence but not undertake their own due diligence.

4.6 Paragraph 32

This paragraph requires the Principal Valuer to remain fully responsible for the valuation performed by an overseas adviser. We do not consider that it is reasonable to make a valuer fully responsible for work it has not undertaken.

4.7 Paragraph 33

Note 2 to paragraph 33 requires that an overseas valuer must be subject to the oversight of a reputable national professional organisation. It may not always be possible for an overseas valuer to meet this requirement. Accordingly, the Practice Note should provide for some flexibility in this regard.

4.8 Paragraph 39

This paragraph requires the management company to prepare a commentary to be included in the offering document that provides a brief description of any previous restructuring, transactions and delineation of title of the overseas property for a period of 5 years before the date of the latest valuation of the property. We submit that this should only be required:

(a) to the extent that the information is available; and

(b) to the extent that the manager considers that it is reasonably necessary for an investor to form a view as whether to invest in the REIT.

Moreover, we submit that the Practice Note should clarify what is meant by "delineation of title".

This comment also applies to paragraph 42(h).

5 Conclusion

We support the proposal to allow SFC authorised REITs to invest overseas. Moreover, we generally support flexibility in the REIT Code with a regime based on investor disclosure rather than prescriptive requirements.

Mallesons Stephen Jaques
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