



THE

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25 February 2013

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The Securities and Futures Commission,  
35/F, Cheung Kong Center,  
2 Queen's Road Central,  
Hong Kong

Council Members  
理事

Dear Sirs,

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Denis G. Brock  
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Charles C.C. Chau  
周致聰

Re: Consultation Paper on Amendments to the Code on Real Estate  
Investment Trusts

I attach the Law Society's Submissions on the captioned Consultation for your  
consideration.

Encl.

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秘書長

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朱潔冰

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## CONSULTATION PAPER ON AMENDMENTS TO THE CODE ON REAL ESTATE INVESTMENT TRUSTS

### The Law Society's Submissions

**Proposal for introducing flexibility in respect of investments in properties under development or engagement in property development activities**

*Question 1: Do you consider that flexibility in respect of property development investments and related activities should be introduced for REITs?*

**Law Society's response:**

Hong Kong currently remains one of the few jurisdictions with rigid restrictions against property development activities for REITs. Based on the experience of the REIT industry in some comparable overseas jurisdictions (including the United States, Australia and Singapore), we welcome the introduction of a reasonable degree of flexibility for property development investments and related activity in the REIT Code and believe such development will benefit the long-term growth of the REIT market in Hong Kong.

*Question 2: Do you consider that the 10% GAV Cap is set as an appropriate threshold?*

**Law Society's response:**

The current proposal is that the aggregate investments in all properties under development and property development activities undertaken by a REIT ("Property Development Costs"), together with the aggregate contract value of the uncompleted units of real estate property acquired by a REIT, should not exceed the maximum threshold of 10% of the REIT's gross asset value ("10% GAV Cap") at all times.

We understand that the proposed 10% GAV Cap is consistent with the existing regulation of some of the Asian REIT markets such as Singapore and Malaysia. We are of the view that the 10% GAV Cap is a reasonable starting point to liberate the restriction on property development investment and related activities. Going forward, the Commission may consider conducting review of the GAV Cap as the REIT industry further matures and as the circumstances may require.

However, we note that as a practical matter, the 10% GAV Cap is only likely to be of use to larger REITs and will be of limited, if any, utility to smaller REITs.

We note that under the proposed amendment to the REIT Code, note 2 to paragraph 7.1 provides that "... the aggregate contract value of such real estate together with the value of the investments in properties under development and property development activities described in 7.2A below shall not exceed 10% of the gross asset value of the scheme at the time of acquisition". Under the proposed new paragraph 7.2A, "...the aggregate investments in all properties under development and property development activities undertaken by the scheme ("Property Development Costs"), together with the aggregate contract value of the uncompleted units of real estate acquired pursuant to Note (2) to 7.1 above, shall not exceed 10% of the gross asset value ("10% GAV Cap") of the scheme at all times." We suggest that note 2 to paragraph 7.1 be amended so that the description of the 10% GAV Cap is stated throughout the REIT Code in a consistent manner.

*Question 3: Do you have any comments on how the Property Development Costs should be calculated?*

**Law Society's response:**

Under the proposed amendment to the REIT Code, "Property Development Costs" refers to the total project costs borne and to be borne by the REIT, inclusive of the costs for the acquisition of land (if any) and the development or construction costs. The upfront calculation of Property Development Costs and, where necessary, subsequent increase should be based on a fair estimate made by the REIT manager in good faith and supported by the opinion of an independent expert acceptable to the Commission. The REIT manager is also expected to include a prudent budget in line with best industry standards or practices to cater for costs overruns that may arise during the course of development.

We note the slightly different approach the Commission has taken in defining the "Property Development Costs" compared with the corresponding concepts in the REIT regulations in Singapore and Malaysia. Under the Code on Collective Investment Schemes issued by the Monetary Authority of Singapore, the total contract value of property development activities undertaken and investments in uncompleted property developments should not exceed 10% of the property fund's deposited property and, for the purpose of this paragraph, the value of the investment refers to the contracted purchase price and not the value of progress payments made to date. Under the Guidelines on Real Estate Investment Trusts issued by the Securities Commission Malaysia, the total value of real estates under construction acquired by a REIT should not exceed 10% of the REIT's total asset value (after the acquisition).

We are of the view that the proposed calculation of the Property Development Costs at an "at cost" basis reflects a slightly more conservative approach to evaluate the weight of the property development activities in a REIT. Having said that, we believe the proposed calculation of "Property Development Costs" is nonetheless adequate for the current purposes.

*Question 4: Do you have any comments on the frequency of periodic updates that should be provided to unitholders on the status of property development investments and related activities?*

**Law Society's response:**

The current proposal is that the REIT manager shall provide periodic updates to investors regarding the status of property development investments and related activities in the interim and annual reports of a REIT. The scope of disclosure includes all material information concerning the property development investments and related activities (such as costs incurred and development progress). We are of the view that the proposed frequency of periodic updates is adequate and generally in line with the disclosure requirements for listed entities in Hong Kong.

*Question 5: What additional safeguards do you consider appropriate to ensure there will not be any material change to overall risk profile of a REIT despite the flexibility to engage in a limited extent of property development investments and related activities?*

**Law Society's response:**

The proposed amendments to the REIT Code have introduced a series of safeguards to ensure that the flexibility to engage in property development investments and related activities will not give rise to any material change to overall risk profile of a REIT, including, among others:

- the REIT manager shall have the requisite resources, competence, expertise, effective internal controls and risk management system to invest in properties under development or to engage in property development activities;
- the REIT shall hold investment in property development for a minimum period of two years; and
- consultation with the trustee and prior announcement are required before the REIT manager enters into any contract to invest in properties under development or engage in property development activities.

We understand that to the extent that the property development transaction or acquisition of vacant land or uncompleted building constitutes a major transaction or very substantial acquisition under Chapter 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules"), such transaction will be subject to reporting, announcement and unitholders' approval requirements under the Listing Rules. Where such transaction constitutes a connected party transaction, independent unitholders' approval may be required under the REIT Code and the Listing Rules.

We also note that certain safeguards proposed in the Consultation Paper have not been incorporated in the proposed amendments to the REIT Code, the Commission may consider issuing a circular regarding the requisite information that requires to be disclosed

regarding the requirements of construction contracts, property development agreement or other agreements the REIT manager enters into the when engaging property development or related activities. As suggested in the Consultation Paper, the REIT manager should ensure that (i) construction contracts contain adequate risks ring-fencing measures, for example, appropriate payment and indemnity terms, such as fixed sum contract, payment by stages, sufficient indemnity against wrongful time delays, etc., so as to protect investors' interests, (ii) the REIT has sufficient resources to finance the property development investments and related activities having regard to the limitations on borrowing under the REIT Code and any exigencies that may arise in the course of construction and (iii) once the 10% GAV Cap is breached, the REIT manager should as soon as practicable inform the Commission and issue an announcement.

### **Proposal for introducing flexibility in respect of investments in financial instruments**

*Question 6: Do you have any comments on the proposed scope of the Relevant Investments and the proposed Maximum Cap?*

#### **Law Society's response:**

It is proposed that a REIT may invest in the following financial instruments ("Relevant Investments"):

- (a) securities listed on the Exchange or other internationally recognized stock exchanges;
- (b) unlisted debt securities;
- (c) government and other public securities; and
- (d) local or overseas property funds.

provided that:

- (i) the value of a REIT's holding of the Relevant Investments issued by any single group of companies may not exceed 5% of the gross asset value of the REIT;
- (ii) the Relevant Investments should be sufficiently liquid, could be readily acquired/disposed of under normal market conditions and in the absence of trading restrictions, and has transparent pricing; and
- (iii) at least 75% of the gross asset value of a scheme shall be invested in real estate that generates recurrent rental income at all times.

Effectively the combined value of the Relevant Investments, together with other miscellaneous non-real estate holdings of the REIT, when aggregated with all of the Property Development Costs and the aggregate contract value of the uncompleted units of real estate acquired by the REIT, should not exceed 25% of the gross asset value of the REIT.

We have no objection to the scope of the Relevant Investments. However, detailed definition should be provided for the terms "securities", "unlisted debt securities",

“government and other public securities” and “property funds”. We note that the proposed maximum cap represents a more conservative approach compared to the REIT regulations in the United States or Australia. We are of the view that the proposed maximum cap is adequate for current purposes.

In addition, the connected party transaction rules should be extended to apply to situations where the REIT contemplates investing in securities issued by connected persons (excluding trustees).

*Question 7: What other safeguards do you consider appropriate to be put in place corresponding to the proposal to allow for the Relevant Investments?*

**Law Society’s response:**

We believe the proposed safeguards proposed in the Consultation Paper are adequate. We suggest that the Commission issuing a circular setting out the safeguarding measures summarized in the Consultation Paper and not yet incorporated in the proposed amendment to the REIT Code.

**The Law Society of Hong Kong  
Investment Products and Financial Services Committee  
25 February 2014**