

Oversight

Real Estate Investment Trusts

August 2003

SFC's Code on
REITs effective
15 August 2003

On 30 July 2003 the Securities and Futures Commission (SFC) finally published its Code on Real Estate Investment Trusts (Code) setting out its requirements to authorise, under Section 104 of the Securities and Futures Ordinance (SFO), HK-REITs. The issuance of the Code, effective from the date of gazette on 15 August 2003, follows an extensive consultation in March and April of this year during which the SFC took representations from industry participants.

The Code is a guideline with which, although not having the force of law, an applicant real estate investment

trust (REIT) must comply in order to be authorised by the SFC (necessary because no fund may otherwise be offered to the public in Hong Kong under the SFO). The SFC's conclusions in the Code overturn its policy of prohibiting retail funds investing in any sort of real estate and of not allowing retail closed-end funds to be authorised. As a general point, the Code is more prescriptive than the Singapore equivalent, this notwithstanding the recent debut of Cheung Kong's HK\$1.1 billion Fortune REIT, investing in 5 Hong Kong shopping malls, on the SGX-ST on 12 August 2003.

What is a REIT?

Whilst the SFC's motivation may have been the earlier successes of the A-REIT and CapitalMall Trust in Singapore or the possible disposal of the Housing Authority's stock, the concept of REITs in their present form dates back to the United States in the 1960s (although the success of US-REITs only followed favourable tax changes in 1986). All REITs, however, tend to have similar characteristics.

REITs are essentially a hybrid product which combine the profile of a listed issuer and the activities of a fund, investing effectively in property but generating an income stream. Typically REITs are not open-ended (i.e. have no redemption facility at the

option of the investor) but derive their liquidity from the secondary market. Unlike a property holding company, a REIT cannot deviate from its core activity of investing in property. When an investor buys units in a REIT, that investor is, in the SFC's view, buying into interests in or benefits from the underlying properties managed and owned by the REIT. Accordingly Rule 3.1 of the Code defines a REIT as being a collective investment scheme that invests primarily in real estate with the aim to provide returns derived from rental income.

HK-REITs must be established as Hong Kong unit trusts (although many REITs in the United States are corporates) and may only invest in Hong Kong property. The SFC has ignored representations made to it during the consultation exercise that this geographical restriction should not be applied (although the SFC has acknowledged that this is a "difficult issue"). In other areas, however, the SFC has displayed greater flexibility – whilst the REIT may not engage in property development and must still hold the properties in question for a minimum of 2 years (a unique Hong Kong requirement), the SFC has accepted that HK-REITs should be permitted to invest in hotels, recreation parks and serviced apartments. Gearing of upto 35% of the HK-REIT's gross asset value (like S-



REITs) is permitted and, like US-REITs, the minimum dividend payout is now 90% of net income after tax rather than the 100% previously proposed by the SFC. This will allow HK-REITs to maintain a cash pool to meet contingencies, including refurbishment of properties.

Hong Kong tax

An overriding consideration in any jurisdiction for the success of REITs has been the question of tax efficiency. The REIT itself, being an authorised collective investment scheme under the SFO, will enjoy the benefit of the profits tax exemption under the provisions of Section 26A(1A) of the Inland Revenue Ordinance.

The SFC has listened to the concerns raised during the consultation period in respect of the proposal that a HK-REIT hold all its interests in the underlying properties directly. If HK-REITs were so required, being unit trusts, they would be at a disadvantage to property companies in that they would not be able to elect to be assessed as to profits tax rather than property tax. Whilst the rates (16%) are the same, allowing the REIT to hold the property interests (as is the case in Singapore) through wholly-owned special purpose vehicles (SPVs) will enable the REIT to utilise the more favourable profits tax deductions. Such allowable deductions include interest expenses,

property repairs, management fees, utilities and depreciation allowances. Further, losses may be carried forward. In addition the proposed requirement that a REIT holds property directly also provided little incentive under the stamp duty regime.

Accordingly, the Code will allow HK-REITs to hold real estate through (upto two layers of) SPVs and those SPVs may in theory be incorporated overseas Hong Kong. The effect of this is to reduce the REIT's stamp duty exposure on the sale of property from 3.75% to 0.2% (if Hong Kong incorporated) or to zero (if incorporated overseas). But the Code imposes additional requirements in respect of the SPVs. Aside from the need to be 100% owned by the REIT, the trustee of the HK-REIT, not the fund manager, must provide the directors of the SPV. Whilst the SPV's holding of the relevant property need not itself be 100%, the SPV must still have a majority stake.

Rule 7.5(b) of the Code provides that the SPV's place of incorporation must be a jurisdiction which has corporate governance standards "commensurate" with Hong Kong. This possibly rules out the British Virgin Islands, a common property holding jurisdiction in Hong Kong. A HK-REIT is allowed to acquire property interests by buying all the issued share capital of an SPV which holds interests in real estate. However the Code requires that an accountant's report must be produced on the P & L of the SPV in respect of the 3 preceding years and the assets and liabilities of the SPV at a date within the previous 6 months. Stamp duty will still be payable on transfers of

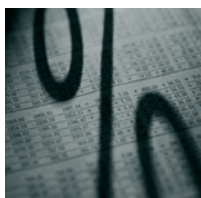
units in HK-REITs in the same way as other Hong Kong stock.

Managers and Trustees

Much of the criticism of the SFC's original proposals focussed on the duplicative nature of the HK-REIT structure, in particular the need for a fund manager to appoint a property manager. Despite management of properties not constituting Type 9 (asset management) regulated activity under the SFO, the SFC stated that the fund manager of a HK-REIT must have such a license (as well as "public" funds experience) and should also delegate property management. The Code modifies this position and provides 3 clear options:

- The fund manager may manage the fund and the actual properties if it has the experience and so wishes;
- The fund manager may manage the fund and may delegate property management to a suitably qualified third party property manager; and
- A new fund manager may be created subject to it having sufficient personnel with skills to manage the fund and the properties.

In all cases the SFC has decided to maintain the requirement that the fund manager is either licensed overseas or SFC licensed (and in the latter case has indicated that an application to be licensed should take 15 weeks). Where the fund manager is licensed overseas, in the same way





as the SFC deals with managers of authorised equities funds, a list of overseas REITs regimes (jurisdictions and relevant regulators) acceptable to the SFC is set out at Appendix A of the REITs Code. As the SFC requires a MOU governing inspections by the relevant overseas regulator, the US SEC, surprisingly, is not on the list (nor is France but Australia, Germany, Ireland, Luxembourg and the United Kingdom are). This means that existing US-REIT's managers would need to establish a HK-REIT fund manager in Hong Kong.

The SFC accepts, however, that closed-end funds do not require retail funds experience and so Rule 5.4 of the Code requires that at least two responsible officers have a 5 years' track record of managing any type of fund. Where the fund manager also performs the property management it must also have key personnel who are professionally qualified to manage real estate. Each must have at least 5 years' real estate management experience.

Another aspect of the unit trust structure which raised concerns in the SFC's first draft of the Code was the role of the trustee relative to the fund manager. Whilst the SFC has reduced some of the more onerous requirements, many still exist and the position of the trustee is perhaps more substantial than necessary. Although the SFC has relaxed the prior REITs experience criteria in order

to create some competition in the market – trustees do not require 3 years rather each must employ personnel with some experience which is "relevant", the trustee still appoints the independent valuer and procures the required annual valuations of the HK-REIT's holdings (but does not have to ensure that these are "fair and reasonable"). The trustees must still take "all reasonable care to ensure", inter alia, that: (1) all transaction are at arm's length and that connected transaction comply with the Code's special requirements under Chapter 8; and (2) the REIT has proper legal title to the underlying properties and that each contract is legal, valid and binding.

However, trustees are permitted to rely on professional advisers in their performance of these tasks. The SFC has also accepted that insurance and disposal of properties (within a year) on termination of the REIT are more properly the responsibility of the fund manager.

Listing and Agents

The Code clarifies, unlike Singapore's Code, that HK-REITs are closed-end only and must be listed, although this must occur within a period acceptable to the SFC. The Code does not purport to override Chapter 20 funds of the Hong Kong listing rules (governing authorised funds seeking listing) and so Chapter 20 will need to be revised. There is no indication of how soon the SFC and the Stock Exchange will amend Chapter 20 which refers only to open-ended authorised funds. In the context of listing, it is important to note that, at present, no closed-end fund can be listed by way of an IPO

notwithstanding the language of Chapter 21 of the Hong Kong listing rules.

As a result of the SFC requiring all HK-REITs to be listed, the SFC has stated that it is discussing streamlining the listing process for all collective investment schemes, including REITs, and this is at "an advanced stage". As a general point, the SFC will vet the constitutional documents and the offering materials of all funds being listed under Chapter 20. REITs will also be required to appoint (by the fund manager) a "listing agent" under Rule 5.11 of the Code. Although not described as such, the listing agent in effect will act as sponsor of the listing and must comply with, amongst other things, the SFC's Corporate Finance Adviser Code of Conduct. Each HK-REIT must retain its listing agent on an ongoing basis to help deal with the Stock Exchange. It is not clear whether a HK-REIT's IPO must be underwritten.

At present there is a flat rate Stock Exchange listing application fee of HK\$20,000 for any SFC authorised fund. It may be the case that this is raised to Chapter 21 rates (a minimum HK\$150,000 Stock Exchange listing application fee). The SFC also intends to seek LegCo consent to increase its application and authorisation fees for HK-REITs. The SFC application and authorisation fees at present would be the same as for other authorised funds, being only HK\$30,000 in total.

Other issues

It is outside the scope of this

Oversight to cover in detail the valuation or disclosure requirements, although it should be noted that with regard to the former there remains an (expensive) requirement for a minimum annual independent valuation (and the independent valuer of each HK-REIT must retire every 3 years). Disclosure in respect of proposed investments will undoubtedly be a major aspect of the preparation of a HK-REIT offering and listing document.

Future fund raising following listing by REITs will be difficult. Pre-emption rights to existing holders must be provided although these may be ignored either where an ordinary resolution has been obtained or where the number of new units issued in aggregate in any financial year does not exceed 20%. Issues to connected persons will still require, notwithstanding the foregoing, approval by way of an ordinary resolution. Where unitholders' resolutions in respect of new issues are required, the fund manager and its connected persons may not vote. In specie subscription is not permitted under these provisions. Even where existing unitholders have pre-emption rights any increase in market capitalisation by more than 50% requires an ordinary resolution.

The Code has detailed "connected person" provisions. "Connected person" for these purposes includes (as well as the trustee, fund manager

or property valuer) "significant" unitholders, i.e. those with 10% or more of the outstanding units. As the disclosure of interests requirements of Part XV of the SFO only apply to shares in listed companies, unitholders in HK-REITs will not be bound to disclose interests which are notifiable. However the Code does provide that the identity of significant unitholders be disclosed (and such persons must themselves notify the trustee). All connected transactions must be at arm's length and be disclosed, having been independently valued in advance. Unitholder approval is not required where the consideration or value of the transaction is below 5% of the latest net asset value. The 5% threshold is calculated by reference to all transactions between the HK-REIT and the connected person in the last 12 months. Non-property management type transactions, e.g. the provision of property agency services, between the HK-REIT and any connected persons are not allowed.

Future Developments

HK-REITs are restricted to investment in Hong Kong which is perhaps the major disappointment for many anticipating the Code. However, the SFC has acknowledged that in due course this will be revised and is engaged in "examining benchmarks". Before any HK-REIT is launched, however, the Stock Exchange will need to revise the Chapter 20 regime applicable to listed funds.

It is clear from the Code that the SFC has sought to be more flexible in its approach. Most importantly the fund

manager is allowed to choose between internal and external property management, the borrowing limit has been increased to 35% of gross asset value, investment in hotels and recreation parks are permitted whilst there is no limit on cash holdings. The use of SPVs will address a major concern. Whether LegCo will allow the SFC to raise its fees is perhaps an open question. The appetite of the investing public for REITs in the present economic climate also remains to be seen.

To find out more...

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