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# Amendments to the SFC's Code on Unit Trusts and Mutual Funds

## Introduction

Amendments to the SFC's Code on Unit Trusts and Mutual Funds (the "Code") allowing collective investment schemes authorised under the Code ("SFC-authorised schemes") to invest in listed real estate investment trusts ("REITs") came into effect on April 22, 2005.

The SFC has also published proposals to lift the geographical restrictions to allow SFC-authorised REITs to invest in real estate anywhere in the world.

The purpose of this note is to highlight the principal features of the amendments to the Code and the new proposals relating to SFC-authorised REITs. The full text of the amended Code, the Consultation Conclusions on Investments in Real Estate Investment Trusts by Collective Investment Schemes Authorised under the Code on Unit Trusts and Mutual Funds (the "Consultation Conclusions") and the Consultation Paper on Draft Practice Note on Overseas Investments by SFC-Authorised REITs are available on the [SFC website](http://www.hksfc.org.hk).

## SFC-Authorised Funds And Unit Trusts Permitted To Invest In Listed REITS From April 22, 2005

### Background

Previously, Chapter 7.14 of the Code prohibited SFC-authorised schemes from investing in any type of real estate or interests in real estate (including options or rights but not shares in real estate companies). Chapter 7.11 further stipulates that while an SFC-authorised scheme may invest up to 10% of its total net asset value in other collective investment schemes, it may not invest in schemes that invest primarily in real estate (ie. REITs).

In November 2004, the SFC issued a circular informing the fund management industry that SFC-authorised schemes may invest in SFC-authorised REITs under Chapter 7.11 of the Code.

### Investments In Listed REITS

Chapter 7.14 of the Code has now been amended as follows:

"A scheme may not invest in any type of real estate (including buildings) or interests in real estate (including options or rights, but excluding shares in real estate companies and interests in real estate investment trusts (REITs) that are listed on a stock exchange).

Note: In the case of investments in such shares and listed REITs, they shall comply with the investment limits as set out in Chapters 7.1 and 7.2".

Accordingly, SFC-authorised schemes are allowed to invested in REITs listed on any stock exchange up to the applicable investment limits. The SFC's November 2004 circular (referred to above) is superseded.

The Code does not specify the types of investment vehicles covered by the term "real estate investment trust". According to the Consultation Conclusions, the term refers to "any investment vehicle that is established to invest primarily in real estate with an aim to generate a recurrent source of dividend income to investors". As such it covers investment vehicles (whether formed as companies or collective investment schemes) that primarily invest in real estate including US REITs and Australian listed property trusts and stapled securities.

Consistent with its approach to investments in listed securities, the Code does not specify stock exchanges on which REITs should be listed. However, given the different risks and characteristics of securities listed on different stock exchanges, the Consultation Conclusions stress the importance of clear disclosure of any risks and the risk-mitigating measures adopted by fund managers.

#### Investment Limits

The investment limits set out at Chapters 7.1 and 7.2 of the Code apply to listed REITs as well as to investments in securities.

Chapter 7.1 limits the value of an SFC-authorised scheme's holding of securities issued by any one issuer to 10% of its total net asset value. Chapter 7.2 further provides that any such scheme may not hold more than 10% of the ordinary shares of any one issuer.

#### Can SFC-authorised REITs invest in the IPO of a REIT seeking to list on a stock exchange?

According to the Frequently Asked Questions about SFC Authorisation of Unit Trusts and Mutual Funds on the SFC web-site, consistent with SFC-authorised schemes' ability to subscribe for securities offered in IPOs seeking to list on a stock exchange, such schemes are also allowed to invest in IPOs of REITs seeking to list.

#### Do Investments in Listed REITs Require the Approval of Shareholders/Unitholders?

Fund managers proposing to invest in listed REITs following the revision of the Code should review the terms of the relevant fund's constitutive and offering documents to determine whether they need to update offering documents, seek investors' approval or provide investors with prior notice.

### Investments In Unlisted Reits

The Consultation Conclusions clarify that the unlisted investments that SFC-authorised schemes can make under Chapters 7.3 and 7.11 include unlisted REITs in the form of companies and collective investment schemes respectively up to the specified limits.

Chapter 7.3 allows schemes to invest up to 15% of their total net asset value in unlisted securities. As already noted, Chapter 7.11 permits investments of up to 10% of a scheme's total net asset value in other collective investment schemes.

## SFC Proposals To Allow SFC-Authorised REITs To Invest In Overseas Properties

### Lifting Of Geographic Restriction

The SFC's Consultation Paper on Draft Practice Note on Overseas Investments by SFC-Authorised REITs (the "Consultation Paper") proposes to remove the restriction on investments to properties in Hong Kong. The SFC has issued a draft Practice Note on Overseas Investments which sets out the competence requirements and obligations of REIT managers of REITs wishing to invest in overseas property. The draft Practice Note specifies key areas which REIT managers should address in their conduct of due diligence in respect of overseas properties and requires proper disclosure of the characteristics and risks of relevant overseas markets. The Practice Note further specifies the obligations of the other parties involved in REITs (the trustee, valuer, auditor, etc).

### Recognition Of Property Portfolio Management Experience For Reit Managers' Licences

The SFC's February 2005 Consultation Paper on Proposed Amendments to Schedule 5 Securities and Futures Ordinance includes a proposed amendment that will clarify that managers of SFC-authorised REITs are required to be licensed by the SFC for Regulated Activity Type 9 (asset management). It is now proposed that the SFC will directly recognize property portfolio management experience as a core competency.

### Review Of The Gearing Ratio

The Consultation Paper seeks views on whether the limit on the gearing ratio should be raised to between 40% and 50%, from the current 35%.

### Other Proposals

The Consultation Paper also asks for views on:

1. allowing special features in REITs, such as payment of management fees by way of issuance of units, subject to proper safeguards being in place;
2. whether the REIT application fee should be levied on a cost recovery basis; and
3. whether management companies should be required to take out professional indemnity and title insurance.

*The purpose of this note is to highlight the principal features of the amendments to the SFC's Code on Unit Trusts and Mutual Funds and the proposals set out in the Consultation Paper on Draft Practice Note on Overseas Investments by SFC-Authorised REITs. Specific advice should be sought in relation to any particular situation.*

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