



SFC PROPOSES AMENDMENTS TO THE CODE ON REITs

Introduction

The Securities and Futures Commission (**SFC**) is conducting a consultation on allowing Real Estate Investment Trusts (**REITs**) greater flexibility to invest in properties under development and financial instruments and engage in property development activities. In its consultation paper, the SFC emphasized the need to balance support for market development and product innovation with investor protection. Appendix A to the consultation paper published by the SFC sets out the proposed amendments to the Code on REITs (**Code**).

The consultation questions are included at the end of the newsletter. The consultation period ended on 26 February 2014.

Background

Property development investments and activities

Currently, the Code restricts REITs from investing in properties under development or financial instruments, or engaging in property development activities, so as to ensure that REITs maintain a generally income-generating profile. The Code allows the acquisition of uncompleted units in an unoccupied non-income producing building (or a building that is in the course of substantial development, redevelopment or refurbishment) (**Acquisition of Uncompleted Units**), but the aggregate contract value of such properties cannot comprise more than 10% of the total net asset value of the REIT. Moreover, REITs cannot invest in vacant land or engage in property development activities (except refurbishment, retrofitting and renovations).

The SFC has received suggestions that the current restrictions in the Code can be relaxed. It was argued that allowing REITs to invest in property developments and the rebuilding of existing properties would:

- help avoid costs of re-modelling assets after an acquisition;
- improve REITs' long-term growth by making it easier to acquire suitable assets;
- lower acquisition costs by allowing earlier participation in a project cycle; and
- old properties to be redeveloped where it would be more economical to do so than to dispose them.

During its soft consultation, the SFC also received arguments that a relaxation of the restrictions in the Code may be contrary to REITs' role as primarily recurrent income generating vehicles, making them seem more like property companies. Additionally, REIT managers may not have the necessary expertise to engage in property development.

Investments in financial instruments

Chapter 7.1 of the Code does not allow REITs to invest in financial instruments. The SFC has received suggestions that allowing REITs to invest in financial instruments would allow them to better manage their cash positions, since it is more difficult to do so with only acquisitions of real estate. On the

other hand, there is concern that increasing flexibility in this area would change the risk profile of REITs and allow REIT managers to make short term and high risk investments.

Proposals

Relaxation of restrictions on investments in property development

The SFC proposes to revise the Code so that REITs would be allowed to invest in property development and related activities, subject to a maximum cap on such investments of 10% of the REIT's gross asset value (**10% Cap**). REITs would still be restricted from acquiring vacant land, except where such acquisitions can be shown to be part-and-parcel of a property development project within the REIT's investment objective or policy. The 10% Cap would apply at all times to all investments in properties under development and property development activities (calculated on an "at cost" basis cumulatively) (**Property Development Costs**), Acquisitions of Uncompleted Units and any acquisitions of vacant land.

The Property Development Costs are the total project costs (including any development costs, construction costs or costs from the acquisition of land) borne by the REIT. It is proposed that the calculation of Property Development Costs would be based on a fair estimate made in good faith by the REIT manager and supported by an independent expert. To account for cost overruns, the estimate would include a buffer based on an opinion provided by the principal valuer or a professional valuer with key personnel who are fellows or associate members of the Hong Kong Institute of Surveyors. The amount of investment in the Acquisition of Uncompleted Units would be the aggregate contract value for those units. The current minimum holding period of two years for properties would be extended to cover the properties completed under the REIT's property development projects.



Relaxation of restrictions on investments in financial instruments

The SFC also proposes to allow REITs to invest in: (a) securities listed on the Stock Exchange of Hong Kong or another recognised stock exchange; (b) unlisted debt securities; (c) government and other public securities; and (d) local or overseas property funds (**Relevant Investments**), provided that:

- the REIT does not hold Relevant Investments in any single group of companies that exceed 5% of the gross asset value of the REIT;
- the Relevant Investments have sufficient liquidity and transparent pricing, and are free from trading restrictions; and
- at least 75% of the REIT's gross asset value is invested in real estate that generates recurrent rental income.

Under the SFC's proposed amendments to the Code, the combined value of the Relevant Investments, property development investments (and related activities), Acquisition of Uncompleted Units and miscellaneous holdings (such as cash and real estate) should not exceed 25% of the gross asset value of a REIT (**Maximum Cap**).

REIT managers

The proposed changes would require that REIT managers have the requisite competence, expertise and effective internal controls and risk management system to undertake property development investments and their related activities and invest in financial instruments in the best interests of the unitholders. REIT managers would need to be aware of all the risks associated with such investments and activities, including construction risks, the risk of default of the counterparties and any risks of rising financing costs. Such risks could be managed by ensuring that:

- construction contracts are entered into at arm's length and on normal commercial terms with adequate risks ring-fencing measures;
- proper due diligence is conducted;
- all applicable laws and regulations are complied with;

- the REIT has sufficient resources to finance the property development investments (subject to limitations on borrowing under the Code);
- competent and adequate staff are available with appropriate skills, resources and expertise; and
- the investment(s) and related activities do not change or increase the REIT's overall risk profile materially.

Disclosure and approval requirements

All the disclosure requirements under Chapter 10 of the Code would generally apply. When entering into a contract for property development investment and related activities, REIT managers would need to consult the trustee and issue an announcement to inform unitholders of the contract, including its key terms and conditions and the risks involved. REIT managers would be required to provide to unitholders periodic updates of their property development investments and related activities in their interim and annual reports. All material information such as costs incurred and the progress of development must be included.

A full investment portfolio of Relevant Investments must be published on the REIT's website, containing key information such as the credit ratings of the investment instruments. This portfolio must be updated monthly and included in the annual and interim reports.

Breaches of the Code

If a REIT exceeds the 10% Cap or the Maximum Cap, the REIT manager must inform the SFC in writing immediately and inform the unitholders in an announcement, including the magnitude of the breach, the reasons for the breach, and the proposed plan of rectification. The REIT manager must do its best to rectify the breach, but it would not be necessary to dispose of the relevant investments if the disposal is prejudicial to the unitholders' interests. The REIT's annual and semi-annual reports should set out the progress of rectification. Amendments to the trust deed of the REIT, subject to the approval of the trustee and unitholders, may be necessary. Any breach of the Code may affect the SFC's view of the REIT manager's fitness and properness adversely.

Consultation Questions

The SFC's consultation paper on the amendment of the Code poses the following questions:

1. Do you consider that flexibility in respect of property development investments and related activities should be introduced for REITs?
2. Do you consider that the 10% GAV Cap is set as an appropriate threshold?
3. Do you have any comments on how the Property Development Costs should be calculated?
4. Do you have any comments on the frequency of the periodic updates that should be provided to unitholders on the status of property development investments and related activities?
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?
6. Do you have any comments on the proposed scope of the Relevant Investments and the proposed Maximum Cap?
7. What other safeguards do you consider appropriate to be put in place corresponding to the proposal to allow for the Relevant Investments?

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