



SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

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

January 2014

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Foreword

The Securities and Futures Commission (“**SFC**”) invites market participants and interested parties to submit written comments on the proposals discussed in this consultation paper or to comment on related matters that might have a significant impact upon the proposals by no later than 26 February 2014. Any person wishing to comment on the proposals should provide details of the organisation whose views they represent.

Please note that the names of the commentators and the contents of their submissions may be published on the SFC’s website and in other documents to be published by the SFC. In this connection, please read the [Personal Information Collection Statement](#) attached to this consultation paper.

You may not wish your name and/or submission to be published by the SFC. If this is the case, please state that you wish your name and/or submission to be withheld from publication when you make your submission.

Written comments may be sent as follows:

By mail to: The Securities and Futures Commission
35/F Cheung Kong Center
2 Queen’s Road Central
Hong Kong

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

By fax to: (852) 2877-0318

By online
submission at: <http://www.sfc.hk>

By e-mail to: reitsconsultation@sfc.hk

All submissions received before expiry of the consultation period will be taken into account before the proposals are finalised and a consultation conclusions paper will be published in due course.

Securities and Futures Commission
Hong Kong

27 January 2014

Personal information collection statement

1. This Personal Information Collection Statement (“**PICS**”) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data¹ will be used following collection, what you are agreeing to with respect to the SFC’s use of your Personal Data and your rights under the Personal Data (Privacy) Ordinance (Cap. 486) (“**PDPO**”).

Purpose of collection

2. The Personal Data provided in your submission to the SFC in response to this consultation paper may be used by the SFC for one or more of the following purposes:
 - (a) to administer the relevant provisions² and codes and guidelines published pursuant to the powers vested in the SFC;
 - (b) in performing the SFC’s statutory functions under the relevant provisions;
 - (c) for research and statistical purposes; or
 - (d) for other purposes permitted by law.

Transfer of personal data

3. Personal Data may be disclosed by the SFC to members of the public in Hong Kong and elsewhere as part of the public consultation on this consultation paper. The names of persons who submit comments on this consultation paper, together with the whole or any part of their submissions, may be disclosed to members of the public. This will be done by publishing this information on the SFC website and in documents to be published by the SFC during the consultation period or at its conclusion.

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4. You have the right to request access to and correction of your Personal Data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data provided in your submission on this consultation paper. The SFC has the right to charge a reasonable fee for processing any data access request.

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5. Personal Data provided to the SFC in response to this consultation paper will be retained for such period as may be necessary for the proper discharge of the SFC’s functions.

¹ Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance (Cap. 486).

² Defined in Schedule 1 of the Securities and Futures Ordinance (Cap. 571) (SFO) to mean provisions of the SFO and subsidiary legislation made under it; and provisions of Parts II and XII of the Companies Ordinance (Cap. 32) so far as those Parts relate directly or indirectly, to the performance of functions relating to prospectuses; the purchase by a corporation of its own shares; a corporation giving financial assistance for the acquisition of its own shares etc.

Enquiries

6. Any enquiries regarding the Personal Data provided in your submission on this consultation paper, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to:

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

7. A copy of the Privacy Policy Statement adopted by the SFC is available upon request.

Consultation Paper on Amendments to the Code on Real Estate Investment Trusts (“REITs”)

Introduction

1. The Commission has kept the regulatory regime of REITs under regular review since its introduction in 2003. In this connection, the Commission has introduced relevant amendments where appropriate from time to time in tandem with international regulatory and local market developments, for example by lifting the geographical restrictions on overseas investments by REITs³, as well as extending the application of the Codes on Takeovers and Mergers and Share Repurchases to REITs⁴.
2. Since the first REIT was listed in 2005, the Hong Kong REIT market has seen steady and stable growth in both breadth and depth. The size of the REIT market has grown close to five times since 2005 in terms of market capitalization. The trading volume of the REIT market also saw sustained increase in average daily turnover since 2009. Hong Kong’s REIT portfolios have also widened to offer investors a diverse choice from retail properties to commercial and hotel properties, and properties in Mainland China. The Hong Kong REIT market further saw a major milestone by listing the world’s first RMB denominated REIT in 2011.
3. Cognizant of the importance of REITs in Hong Kong’s continued development as an international premier asset management centre, the Commission has maintained regular dialogues with industry participants to stay up-to-date on changes to the market landscape, and to keep in view the existing regulatory regime. During the past year, the Commission met with various stakeholders and consulted the Committee on REITs to discuss issues pertaining to the development of the Hong Kong REIT market.
4. Taking into account the feedback received from the discussions and the regulatory developments in comparable overseas jurisdictions, the Commission believes that it is an appropriate time to amend the Code on Real Estate Investment Trusts (“**REIT Code**”) to allow for greater flexibility in the investment scope of REITs with respect to (a) investment in properties under development or engagement in property development activities and (b) investment in financial instruments.
5. In considering the proposed amendments to the REIT Code, the Commission is mindful of the need to strike a proper balance between facilitating market development and competitiveness on the one hand, and ensuring the protection of investors’ interests and market integrity on the other.
6. The Commission has noted the recent research report (“**FSDC Report**”) released by the Financial Services Development Council (“**FSDC**”)⁵ pertaining to the development of the Hong Kong REIT market in the course of finalising the proposals in this consultation. We take note that the FSDC Report is also supportive of our proposal to allow REIT managers greater flexibility to invest in properties under development or to engage in

³ Consultation Paper on Draft Practice Note on Overseas Investments by SFC-Authorised Real Estate Investment Trusts issued in March 2005 and the corresponding consultation conclusions paper issued in June 2005

⁴ Consultation Paper on (1) the proposal to extend the application of the Codes on Takeovers and Mergers and Share Repurchases to SFC-authorized real estate investment trusts and related amendments and (2) the proposal to extend Parts XIII to XV of the Securities and Futures Ordinance to listed collective investment schemes issued in January 2010 and the corresponding consultation conclusions paper issued in June 2010

⁵ “Developing Hong Kong as a capital formation centre for Real Estate Investment Trusts” released by FSDC on 18 November 2013

property development activities. Other proposals of the FSDC Report will be discussed briefly in the final section in this consultation paper⁶.

7. This consultation paper sets out the various views gathered from our extensive soft consultations from different industry stakeholders on the proposals for a more comprehensive understanding and deliberation of the relevant issues involved so as to facilitate meaningful feedback.
8. A consultation conclusions paper will be published as soon as practicable after the end of the consultation period.

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

Background

9. The REIT Code imposes certain investment restrictions on REITs to ensure that a REIT would maintain a generally income-generating profile. Specific provisions in connection with constraints on property development or acquisition of uncompleted units of properties under development are extracted below:
 - (a) *The scheme may acquire uncompleted units in a building which is unoccupied and non-income producing or in the course of substantial development, redevelopment or refurbishment, but the aggregate contract value of such real estate shall not exceed 10% of the total net asset value of the scheme at the time of acquisition* (Note (2) to 7.1 of the REIT Code) ("**Acquisition of Uncompleted Units**");and
 - (b) *The scheme is prohibited from investing in vacant land or engaging or participating in property development activities. For this purpose, property development activities do not include refurbishment, retrofitting and renovations* (7.2 of the REIT Code).
10. The investment restrictions are imposed mainly with a view to ensure that REITs primarily invest in income-generating real estate. In our consultation conducted in 2003 on the draft REIT Code⁷, the Commission pointed out that it was mindful that property development activities could undermine the fundamental principle of rental income generation. We were also mindful that such activities require skills that are different from those of REIT management, which focuses on property portfolio management for the generation of recurrent income.
11. The Commission has received various comments and enquiries from some REIT managers during the past year regarding various proposals to invest in properties under development or engage in property development activities. Specifically, there were comments acknowledging that while the REIT Code allows REITs to conduct acquisitions

⁶ The rest of the recommendations set out in the FSDC Report concerning matters such as tax, stamp duty and legislative changes are issues for policy decisions by the Administration.

⁷ A Consultation Paper on the Draft Code on Real Estate Investment Trusts was issued by the Commission in March 2003 and the Consultation Conclusions on the Draft Code on Real Estate Investment Trusts was issued in July 2003.

of uncompleted properties subject to the threshold described above or by way of forward purchase arrangements, greater flexibility is desired to enable REITs to conduct property development investments and related activities for portfolio expansion or asset enhancement by rebuilding existing properties for the following reasons:

- (a) the target properties acquired may not fully meet the design and specifications required by the particular REIT, and it could be costly for REITs to re-model the assets after acquisition to suit the REIT's individual needs;
- (b) the "design-and-build" model could feed a REIT's long term strategic and organic growth in particular where it would be difficult to identify suitable yield enhancing assets for acquisition;
- (c) early participation in a project cycle could allow REITs to enjoy lower acquisition costs of a property; and
- (d) where the existing properties of the REIT have become worn out and the cost of repair would outweigh the costs and returns from rebuilding the properties, it might be more viable for the redevelopment of such properties than to dispose of them in a dilapidated condition at less than optimal prices, thus adversely impacting the returns to investors.

It is therefore expected that lifting the prohibition on property development investments and related activities would be beneficial to the development of REITs and investors.

12. In light of the above comments received, we have conducted soft consultations with various market participants on the possibility to enhance the current regime by revisiting the restrictions on investing in properties under development or engaging in property development activities. While there was support for the proposals for the reasons set out above, not all REIT managers and industry players agreed with the proposal. A sizeable proportion of the REIT managers expressed reservations, citing the following:

- (a) property development investments and related activities, their associated risks, and extended time-span taken before generation of returns may not be fully consistent with a REIT's profile as a primarily recurrent income generating vehicle, and may blur the distinction between REITs and property companies; and
- (b) the REIT manager may not have the expertise to conduct and oversee property development, which is different from that of property management for rental income.

Proposals

13. Taking into account the comments received and having considered the regulatory requirements in comparable overseas jurisdictions, the Commission considers that on balance, a certain degree of flexibility in property development investments and related activities would be merited to facilitate long-term growth of the Hong Kong REIT market. However, given the nature of REITs as investment vehicles that primarily invest in real estate with the aim to provide returns to investors derived from recurrent rental income, and the risks associated with property development investments and related activities, limits are proposed to address the concerns raised so far.

Proposed threshold limits

14. The Commission proposes to revise 7.2 of the REIT Code to allow REITs to undertake property development investments and related activities⁸, subject to a maximum threshold of 10% of the REIT's gross asset value ("**10% GAV Cap**"). Such 10% GAV Cap shall be inclusive of the Acquisition of Uncompleted Units currently permissible under Note (2) to 7.1 of the REIT Code⁹.
15. In other words, the aggregate of all investments in (i) properties under development and property development activities undertaken by the REIT ("**Property Development Costs**"), calculated on an "at cost" basis cumulatively; and (ii) Acquisition of Uncompleted Units, are subject to the 10% GAV Cap at all times.
16. It is proposed that Property Development Costs would be the total project costs borne and to be borne by the REIT, inclusive of the costs for the acquisition of land (if any)¹⁰ and the development or construction costs of the project. In ensuring compliance with the 10% GAV Cap, the Commission proposes that the upfront calculation of Property Development Costs, and any increase in such costs subsequent to the commencement of a property development project, 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.
17. REIT managers are expected to include a prudent buffer in line with best industry standards or practices to cater for cost overruns that may arise during the course of development. In this connection, the Commission would generally be prepared to accept an opinion prepared by the principal valuer of the REIT or other professional valuers with key personnel who are fellow or associate members of the Hong Kong Institute of Surveyors and who are qualified to perform property valuations pursuant to published standards of the Hong Kong Institute of Surveyors or the International Valuation Standards issued from time to time by the International Valuation Standards Committee.
18. The basis for calculation of the investment in Acquisition of Uncompleted Units shall remain as the aggregate contract value as currently referred to under Note (2) to 7.1 of the REIT Code.

Investment in vacant land

19. In relation to the current prohibition on investment in vacant land, the Commission maintains the view that the pure hoarding or speculative trading of vacant land by REITs would not be consistent with its product nature which is to generate recurrent rental income.

⁸ References to "property development investments and related activities" in the proposal include re-development of properties in the existing portfolios of REITs but do not include "refurbishment, retrofitting and renovations" which are currently excluded under the REIT Code. However, REIT managers are expected to act in good faith and observe the distinction between re-development and a genuine refurbishment, retrofitting and renovation as these terms are reasonably and commonly understood and having regard to industry norms.

⁹ Under Note (2) to 7.1 of the REIT Code, the maximum threshold currently applicable to the Acquisition of Uncompleted Units is 10% of the total net asset value of the REIT. Under the proposal, this threshold will be expanded to 10% of the gross asset value of the REIT which will also encompass the Property Development Costs.

¹⁰ For example, in the case of re-development of existing property, no additional payment may be required to be made by the REIT to acquire the land on which the property is re-developed.

20. However, the Commission recognises that in connection with investment in property development projects, it may involve acquisition of vacant land and is prepared to allow a REIT to, subject to the 10% GAV Cap, make such acquisition provided that the REIT manager can demonstrate that the acquisition of the vacant land is part-and-parcel of a property development project within the investment objective or policy of the REIT.

Minimum holding period

21. Having regard that property development investments and related activities are permitted with the aim to enable REITs to derive a stable source of rental income from those properties upon completion of development, the Commission proposes that the existing minimum two-year property holding period requirement under 7.8 of the REIT Code should be extended to cover the properties completed under the REIT's property development projects as well¹¹.

Responsibilities and duties of REIT managers

22. Any decision made by REIT managers to undertake property development investments and related activities must be made solely in the best interests of unitholders, to whom the REIT managers owe a fiduciary duty. In addition, REIT managers who decide to undertake property development investments and related activities must have the requisite competence, expertise and effective internal controls and risk management system for conducting such investments or activities.
23. Accordingly, before making any decision to undertake property development investments and related activities, a REIT manager would be expected to carefully assess and put in place an effective risk control system to ensure that the relevant risks associated with such property development investments and related activities are managed effectively¹². These risks include, for example, (i) constructions risks (ii) risk of default of the construction project counterparties; and (iii) risk of rising financing costs due to possible delay in completion or changing market environment etc.
24. In this connection, REIT managers should consider how to reasonably mitigate and contain the above risks by:
- (a) ensuring that construction contracts are entered into at arm's length on normal commercial terms and contains 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;
 - (b) conducting proper due diligence to ensure all relevant government and regulatory approvals required for property development investments and related activities have been obtained and all applicable laws and regulations are complied with;
 - (c) ensuring 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;

¹¹ References to properties completed under the REIT's development projects shall include existing properties which have undergone re-development.

¹² See also the REIT manager's duty under 5.2(b)(i) of the REIT Code.

- (d) ensuring it has competent and adequate staff with sufficient and appropriate skills, resources and expertise in place, either as part of their in-house skills or by way of outsourcing to a competent external party (e.g. engaging a reputable, suitably qualified and financially sound developer or contractor to undertake the development or construction activities) under their oversight, to manage the property development investments and related activities; and
- (e) ensuring that the property development investments and related activities would not result in a material change or increase in the overall risk profile of the REIT.

Disclosure, reporting and unitholders' approval requirements

- 25. To keep unitholders apprised of the position of the property development investments and related activities undertaken by a REIT, it is proposed that the REIT manager shall provide periodic updates to investors about the status of property development investments and related activities in the interim and annual reports of REITs. The REIT manager shall ensure that all material information concerning these property development investments and related activities (such as costs incurred, development progress, etc.) is set out in such updates.
- 26. The REIT Code provisions under Chapter 10 regarding reporting and documentation requirements will apply equally to the property development investments and related activities undertaken by REITs. Generally, REIT managers are expected to consult the trustee and issue an announcement to inform unitholders upon the REIT entering into a contract for property development investment and related activities, including a summary of the key terms and conditions and the risks involved. Depending on the size, nature, and counterparties of the transaction, REIT managers should also ensure all other applicable requirements under the REIT Code are complied with, such as unitholders' approval, issue of circular and requirements relating to connected party transactions and the general disclosure obligation under 10.3 of the REIT Code.
- 27. Our proposal is broadly in line with comparable overseas regimes. We note for example that Singapore, Malaysia¹³, United States and Australia¹⁴ similarly allow REITs to undertake property development investment and/or related activities while Japan maintains a prohibition. There is a cap imposed on the maximum investment in such activities in some of these jurisdictions, for example Singapore and Malaysia impose a similar maximum cap on 10% of total assets held by the REIT for such investments.
- 28. We have consulted the Committee on REITs which is generally supportive of the proposal.
- 29. It is believed that the proposal would allow additional flexibility for REIT managers to grow their REIT businesses for the benefit of the REIT unitholders and facilitate the long-term development of the Hong Kong REIT market.
- 30. Please refer to **Appendix A** to this consultation paper for the indicative draft of the proposed amendments to the REIT Code.

¹³ Property development activities are restricted but a fund may enter into arrangement at any stage during the construction phase to acquire real estates subject to certain criteria.

¹⁴ Commonly in the form of stapled-securities.

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?

Proposal for introducing flexibility in respect of investments in financial instruments

Background

31. Currently, the extent to which SFC-authorized REITs may invest in financial instruments is restricted by 7.1 of the REIT Code, which provides that a REIT shall only invest in real estate.
32. Via recent discourse with the industry, the Commission has received comments from some REIT managers inviting the Commission to consider giving REIT managers more flexibility in undertaking investments in financial instruments such as shares of listed companies or units in property funds or other listed REITs and debt instruments, to better manage a REIT's cash position in the interests of unitholders. In particular, it was pointed out that it could be difficult to identify suitable property acquisition opportunities due to market conditions.
33. During soft consultations with various stakeholders on this area, while the Commission has received considerable support for liberalising the scope of investment, cautions were also received that drastic increase in such flexibility may vary the risk profile of REITs if the REIT manager chose to engage in speculative high risk investments. This could distract REITs from focusing on property management and recurrent income generating activities. The concern voiced by several industry players is that REIT managers may be tempted to pursue short term or high risk returns from investments in financial instruments which may offer higher returns than real estate acquisitions. Some REIT Committee members also questioned whether different expertise might be required from REIT managers.

Proposals

Proposed threshold limits

34. Taking into account the benefits to investors by making available a broader range of investment options to REITs on the one hand, and maintaining the REIT's recurrent income generating profile and protecting investors' interests on the other, the Commission proposes to amend the REIT Code to introduce flexibility for REITs to invest in certain other financial instruments up to a maximum threshold described below.
35. It is proposed that subject to the restrictions outlined below, a REIT may invest in the following financial instruments ("**Relevant Investments**"):
- (a) securities listed on the Stock Exchange of Hong Kong Limited or other internationally recognised stock exchanges¹⁵;
 - (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 REIT shall be invested in real estate that generates recurrent rental income at all times.
36. As such, the combined value of the Relevant Investments held by a REIT, together with the REIT's other miscellaneous holdings such as cash and cash equivalent items, real estate related assets¹⁶ and hedging instruments¹⁷, when aggregated with all of the property development investments and related activities undertaken by the REIT and Acquisition of Uncompleted Units, should not exceed 25% of the gross asset value of the REIT ("**Maximum Cap**"). This proposed Maximum Cap would help to maintain a REIT's profile as primarily a recurrent rental income generating vehicle.

¹⁵ For the avoidance of doubt, the requirement under 7.7A of the REIT Code for the management company to ensure that the scheme has majority ownership and control in each property at all times does not apply to a REIT's indirect ownership of any property due to the REIT's investment in the Relevant Investments.

¹⁶ This broadly refers to items installed or used in association with real estate, such as furniture, carpets, furnishing, machinery and plant and equipment, etc.

¹⁷ Mark-to-market value of hedging instruments as stated in the financial statements of the REIT.

Responsibilities and duties of REIT manager

37. The Commission would like to highlight that the flexibility proposed to be introduced for REITs to invest in these Relevant Investments should not materially affect the primary nature and expected risk profile of the REIT.
38. In making any Relevant Investments, REIT managers as fiduciaries must satisfy themselves that the investments are in the best interests of the unitholders. REIT managers must also satisfy themselves that they have sufficient and appropriate skills, resources, risk management processes and controls in place to manage and monitor the Relevant Investments and any associated risks. The trustee should also take all reasonable care to ensure that the Relevant Investments are made in accordance with the provisions of the constitutive documents.
39. The REIT manager should, in particular, be mindful that the making of any such Relevant Investment should not result in any material change in the overall risk profile of the REIT or expose the REIT to significant increase in risks inconsistent with the fundamental recurrent income generating nature of the REIT¹⁸. REIT managers are expected to manage the Relevant Investments and monitor them on an on-going basis to ensure that the Maximum Cap should be observed.

Disclosure requirements

40. To provide transparency on the Relevant Investments which may be made by a REIT, the Commission proposes that the REIT manager should publish the full investment portfolio of the Relevant Investments of REITs with key information relevant to such Relevant Investments (e.g. credit ratings of the instruments invested, if applicable) on its website on an ongoing basis which shall be updated monthly within five business days of each calendar month end. Such information should also be included in the annual and interim reports of REITs.
41. The REIT Code provisions under Chapter 10 regarding reporting and documentation requirements are expected to apply equally to the Relevant Investments undertaken by REITs. In particular, the Commission would expect the REIT manager to consider the issue of announcements where appropriate in relation to the Relevant Investments having regard to the general disclosure obligation under 10.3 of the REIT Code.
42. Our proposal is generally in line with comparable overseas regimes. For example, Singapore, Malaysia, United States, Australia and Japan allow investments in broadly similar instruments as set out in our proposal, with certain maximum investment thresholds prescribed by some of these jurisdictions¹⁹.
43. We have consulted the Committee on REITs which is generally supportive of the proposal.
44. Please refer to **Appendix A** to this consultation paper for the indicative draft of the proposed amendments to the REIT Code.

¹⁸ As such, it is generally expected that REIT managers should not invest in any high risk or complex financial instruments or enter into any securities lending, repurchase transactions or other similar over-the-counter transactions.

¹⁹ In Singapore, it is generally required that 75% of a fund's total assets must be invested in real estate, and thus not more than 25% of the total assets may be invested in other assets. Similarly in the United States, it is generally required that at least 75% of the value of the fund's total assets is represented by real estate assets, cash and cash items and government securities and not more than 25% of the value of the fund's total assets is represented by other securities.

Questions:

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?

General

45. Where the 10% GAV Cap and/ or the Maximum Cap is exceeded, the REIT manager should inform the Commission in writing immediately and issue an announcement to inform unitholders as soon as reasonably practicable. The REIT manager shall provide to the Commission and unitholders information on the magnitude of and reasons for the breach and the proposed rectification plan, including the proposed period for rectification.
46. While the REIT may not be required to dispose of such investments if the disposal is prejudicial to the interests of the unitholders, the REIT manager shall use its best endeavours to rectify the breach or take reasonable measures to do so as soon as reasonably practicable, depending on the nature and circumstances of the breach on a case-by-case basis. The REIT manager should inform the Commission and unitholders as to the progress of the rectification in the annual and semi-annual reports of the REIT.
47. REIT managers should note that breaches of the REIT Code may cause the Commission to consider whether such failure adversely reflects on the person's fitness and properness and the suitability of the REIT to remain authorized.
48. Implementation of the above proposals would require amendments to the trust deed of the relevant REIT. Such amendments are subject to the approval of the unitholders and the trustee of the REIT, who has a fiduciary duty to oversee the activities of the REIT manager under the REIT Code.

Miscellaneous amendments

49. To maintain consistency in wording adopted by other codes and guidelines issued by the Commission, a technical amendment is also proposed to be made to the REIT Code by adding in the "Explanatory Notes" section that the Commission may modify or relax the application of a requirement therein if the Commission considers that, in particular circumstances, strict application of the requirement would operate in an unduly burdensome or unnecessarily restrictive manner. The amendment is in line with our existing regulatory approach.

Other issues

50. We note that the FSDC Report also contains proposals relating to other aspects of REITs. One of the proposals relates to the removal of profits tax on REITs. While such removal is expected to be beneficial to Hong Kong REITs, it should be noted that unlike other jurisdictions, no tax is levied at individual unitholder level on dividends or capital gains in Hong Kong at present. Therefore, a removal of profits tax could result in Hong Kong REITs becoming completely tax-free. Whether this would resonate well within Hong Kong's overall tax structure is of course a matter of government tax policy.
51. The FSDC Report also proposed to extend the compulsory acquisition and scheme of arrangement provisions under the Companies Ordinance to REITs. As mentioned in the Commission's market consultation in 2010 in relation to the extension of the Codes on Takeovers and Mergers and Share Repurchases ("Takeovers Code") to REITs, legislative change is required to effect an extension of such provisions. In fact, currently REITs may be privatised by disposing all of its assets followed by a delisting provided that the relevant requirements under the Takeovers Code are complied with. With the extension of the Takeovers Code to REITs, REIT unitholders are protected to the same extent as shareholders of a listed company in takeovers, mergers and acquisitions.
52. The Commission will continue to keep in view developments in both Hong Kong and international REIT markets. In formulating the regulations for Hong Kong REITs, the Commission seeks to ensure there is a good balance between supporting market development and product innovation on the one hand, and upholding investor protection on the other.

Seeking comments

53. The SFC welcomes any comments from the public and the industry on the proposals made in this consultation paper and the indicative draft of the proposed amendments to the REIT Code in **Appendix A** to this consultation paper. Please submit comments to the SFC in writing by no later than 26 February 2014.

Proposed amendments to REIT Code

Explanatory Notes:

The Securities and Futures Commission (“Commission”) is empowered under section 104(1) of the Securities and Futures Ordinance (Cap. 571) (“SFO”) to authorise collective investment schemes, subject to such conditions as it considers appropriate.

This Code on Real Estate Investment Trusts together with the Practice Note(s) issued from time to time (“Code”) establish guidelines for the authorisation of a collective investment scheme which is a real estate investment trust (“REIT”).

The Commission is empowered under section 105(1) of the SFO to authorise the issue of an advertisement or invitation to the public in Hong Kong to invest in a collective investment scheme, subject to such conditions as the Commission considers appropriate.

The Commission may at any time review its authorisation of a REIT, or of an advertisement or invitation relating thereto, and may modify, add to or withdraw any of the conditions of such authorisation, or revoke the authorisation, as it considers appropriate.

The Commission may modify or relax the application of a requirement in this Code if it considers that, in particular circumstances, strict application of the requirement would operate in an unduly burdensome or unnecessarily restrictive manner.

The issue of a false or misleading advertisement or an invitation to the public in Hong Kong to invest in an unauthorised collective investment scheme may amount to an offence under section 103(1) of the SFO.

This Code does not have the force of law and shall not be interpreted in a way that will override the provision of any law.

Chapter 7: Investment Limitations and Dividend Policy

Core Requirements

7.1 The scheme shall primarily ~~only~~ invest in real estate.

Notes: (1) The real estate shall generally be income-generating. At least 75% of the gross asset value of the scheme shall be invested in real estate that generates recurrent rental income at all times.

(2) The scheme may acquire uncompleted units in a building which is unoccupied and non-income producing or in the course of substantial development, redevelopment or refurbishment, but 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 ~~net~~ asset value of the scheme at the time of acquisition.

(3) *The offering document shall clearly disclose if the scheme intends to acquire further properties during the first 12 months from listing.*

7.2 The scheme is prohibited from investing in vacant land unless the management company has demonstrated that such investment is part-and-parcel of the property development activities undertaken pursuant to 7.2A below and within the investment objective or policy of the scheme, or engaging or participating in property development activities. For this purpose, ~~property development activities do not include refurbishment, retrofitting and renovations.~~

7.2A A scheme shall not engage or participate in property development activities unless 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. For this purpose, investment in properties under development and property development activities do not include refurbishment, retrofitting and renovations.

Notes: (1) Property Development Costs refer to the total project costs borne and to be borne by the scheme, 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 any subsequent increase should be based on a fair estimate made by the management company in good faith and supported by the opinion of an independent expert acceptable to the Commission.

(2) The management company is expected to include a prudent buffer in line with best industry standards or practices to cater for cost overruns that may arise during the course of development.

(3) Any decision made by the management company to invest in properties under development or to engage in property development activities must be made solely in the best interests of unitholders.

(4) The investments in properties under development or property development activities should not result in a material change in the overall risk profile of the scheme.

(5) To invest in properties under development or to engage in property development activities, the management company must have the requisite resources, competence, expertise, effective internal controls and risk management system for conducting such investments or activities.

(6) Generally, the management company is expected to consult the trustee and issue an announcement to inform unitholders upon the scheme entering into a contract to invest in properties under development or to engage in property development activities and to provide periodic updates in the interim and annual reports of the scheme. The management company shall ensure that all material information concerning these property development investments and related activities is set out in such announcements and updates.

7.2B The scheme 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 scheme’s holding of the Relevant Investments issued by any single group of companies may not exceed 5% of the gross asset value of the scheme;
- (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.

Notes: (1) The combined value of the Relevant Investments, together with other miscellaneous non-real estate holdings of the scheme, when aggregated with all of the Property Development Costs pursuant to 7.2A and the aggregate contract value of the uncompleted units of real estate acquired pursuant to Note (2) to 7.1, should not exceed 25% of the gross asset value of the scheme. The management company is expected to manage the Relevant Investments and monitor them on an on-going basis to ensure that such 25% limit of the gross asset value of the scheme should be observed.

(2) To provide transparency on the Relevant Investments which may be made by a scheme, the management company shall publish the full investment portfolio of the Relevant Investments of the scheme with key information relevant to such Relevant Investments (e.g. credit ratings of the instruments invested, if applicable) on its website on an ongoing basis which shall be updated monthly within five business days of each calendar month end. Such information shall also be included in the annual and interim reports of the schemes.

7.8 The scheme shall hold each property within the scheme for a period of at least two years, unless the scheme has clearly communicated to its holders the rationale for disposal prior to this minimum holding period and its holders have given their consent to such sale by way of a special resolution at a general meeting.

Notes: (1) In the case where a property is held through a special purpose vehicle, this provision applies as well to the disposal of any interest in such special purpose vehicle.

- (2) In the case of investments in properties under the scheme's property development activities pursuant to 7.2A, the scheme shall hold such properties within the scheme for a period of at least two years from the completion of the properties.

Chapter 10: Reporting and Documentation Announcements

10.4 The following are examples of information that would require disclosure under 10.3. These examples do not constitute a complete list:

- (x) a proposal to terminate the scheme; or
- (y) a proposal to vary the intention stated regarding acquisition of properties within the first 12 months of listing (see Note (3) to 7.1); or
- (z) a scheme enters into a contract to invest in properties under development or to engage in property development activities pursuant to 7.2A.

List of specific questions raised in the Consultation Paper

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