CompliancePlus Consulting

Submission to Consultation Paper Issued by the Securities and Futures Commission on the Proposed Amendments to the Code on Real Estate Investment Trusts

Josephine Chung

Director

CompliancePlus Consulting Limited

August 2020

For inquiries on this submission, please contact Josephine Chung at jchung@complianceplus.hk. CompliancePlus Consulting Limited understands and agrees that our name and/or submission may be published to the public.

Introduction

The Securities and Futures Commission (The "SFC") issued a Consultation Paper in June 2020 on the Proposed Amendments to the Code on Real Estate Investment Trusts ("REIT") ("Consultation Paper"). CompliancePlus is pleased to provide feedback on the Consultation Paper as below:

Amendment 1: Minority Holdings for REITs

Question 1: Do you agree with the proposal to allow flexibility for REITs to invest in Minority-owned Properties? Please explain your view.

CompliancePlus agrees with the proposal to allow flexibility for REITs in Hong Kong to invest in Minority-owned Properties. Firstly, the proposal provides more options for REITs listed in Hong Kong to acquire properties and facilitate further development of their portfolios. Secondly, the proposal enhances the global competitiveness of the Hong Kong REIT market by making it more in line with overseas markets. Lastly, investing in Minority-owned properties decreases the risk for REITs in individual projects by decreasing their exposure to these properties.

Increase in Options for the Acquisition of Properties to Facilitate Portfolio Development

Previously, REITs in Hong Kong were restricted to 10% of the REIT's GAV for investments in Minority-owned properties. Concurrently, this restriction limits the REITs options in choosing investments when determining the asset allocation for their portfolios.

By removing this restriction, it follows that REITs can now adjust their portfolio according to their individual circumstances and increase allocation in minority-owned properties if doing so will improve their performance. Under the previous restriction, REITs who could have performed stronger by increasing their allocation in Minority-owned properties were unable to do so hence limiting their portfolio development.

Furthermore, certain overseas jurisdictions such as Australia have restrictions that prohibit foreign investors from holding majority stakes in domestic properties. 80% of REITs listed in Singapore have exposure to overseas properties. By following suit, increasing Hong Kong REIT's flexibility to increase their exposure to such opportunities can assist in increasing such overseas investments. Therefore,

increasing the flexibility for REITs to invest in Minority-owned properties will allow them to better tailor their allocation of properties to suit their individual circumstances and further advance the development of their portfolios.

Enhance Global Competitiveness of Hong Kong in the REIT Market

The flexibility in investing in Minority-owned properties have long been provided to REITs listed in other mature markets. Currently, there are no explicit restrictions on investing in minority holdings for REITs listed in the United States, United Kingdom, Australia, or Japan. Thus, by aligning the Hong Kong REIT market with overseas markets and providing this flexibility to local REITs, the global competitiveness of Hong Kong REITs is sure to improve.

This will level the playing field for REITs listed in Hong Kong and provide them with a friendlier market necessary to outperform their competitors. This increased competitiveness of being listed in Hong Kong may also attract foreign REITs to list on the Hong Kong Stock Exchange.

Decrease in Risk of Investment Losses by Lowering Exposure

Real estate projects are inherently costly to finance, and to ask a REIT to finance it entirely and take majority ownership is akin to asking them to assume the risk of losing the entire investment if the project goes south.

Minority-owned properties greatly decrease this risk as it lowers the size of the investment needed for a REIT to invest in a property. While this decreases the potential profit a REIT can make, it also lowers the potential for losses as the REIT’s exposure to each property is smaller.

Furthermore, as the flexibility of not having majority ownership in each property allows REITs to make investments with less investment outlay, REITs can now invest in more properties across different sectors. This allows for a more diversified portfolio even if the total assets under management remain the same and hence lower unsystematic risk. Therefore, by decreasing the risk that REITs have to assume with majority-owned properties, the flexibility of investing in more Minority-owned properties protects REITs' risk profile, and their unitholders' best interests.

We believe that the above reasons justify the benefits that come with SFC's proposal of allowing more flexibility for REITs listed in Hong Kong to invest in Minority-owned properties. At the same time, suitable requirements and regulations have to be upheld to protect unitholders' best interests and prevent the REIT's risk profile from worsening.

Question 2: Do you consider that proposed overarching principles and specific conditions for Qualified Minority-owned Properties are appropriate? Do you have any comments on the principles and conditions proposed? Please explain your view.

CompliancePlus considers the proposed overarching principles and specific conditions for Qualified Minority-owned Properties to be appropriate for two reasons. Firstly, these principles and conditions ensure that these investments stay in line with the REIT's investment strategy. Secondly, they adequately protect the REIT's risk profile and unitholders from potential losses.

Keep New Investments in Line with REIT's Investment Strategy

Maintaining consistency between the fund's investments and its investment strategy is of fundamental importance. Even if an investment can assist in decreasing unsystematic risk through diversification, it should not be executed if the investment deviates from the REIT's investment strategy. This is because doing so would fundamentally change the REIT's profile and hence can render the REIT inappropriate for investors whose risk tolerance, time horizon, and investment objective are incompatible with the new profile.

Protect REIT's Risk Profile and Unitholders from Potential Losses

The inclusion of specific conditions for Minority-owned properties to satisfy before being considered "qualified" can suitably protect the REIT's risk profile and reduce the risk of unitholders suffering from potential losses. For example, specifying in the joint ownership agreement that not less than the majority of annual distributable income must be distributed ensures that the recurrent income nature of a REIT is upheld. Another example would be the inclusion of veto rights over key matters. By ensuring so, the REIT can suitably prevent individual properties from making bad decisions.

While CompliancePlus deems the proposed overarching principles and specific conditions for Qualified Minority-owned Properties to be appropriate, we have some comments and have summarized them below:

(a) Under 7.7C of the appendix, (i) states that "There are good governance and adequate measures in place to avoid conflicts of interests…". These "adequate measures" and "good governance" should be further specified so that they can be practically applicable to REIT managers. An example would be the clear segregation of different functions within the REIT.

(b) Under the same selection of the appendix, (g) states that "Where applicable, the scheme shall have no less than proportionate board representation". This "proportionate board representation" should be further defined. An example could be majority representation (>50%) or sufficient representation to have voting rights over key matters.

(c) Under the same section but within the Notes of 7.7C, (2)(iv) mentions that the REIT should include certain pieces of financial information on the performance of the Qualified Minority-owned property in the annual and interim reports of the scheme. However, this does not specify including the previous historical performance of such properties. We believe that the historical return and other historically relevant financial information should also be obtained to validate the Minority-owned Property's ability to satisfy the qualifications.

(d) While the proposal explicitly states that unitholder approval is required before a REIT can acquire Minority-owned properties, it does not explicitly specify that approval from trustees is also required. Although this should be implied already, we believe that the requirement for trustee approval should also be explicitly stated to avoid any potential conflicts of interest by notifying all relevant parties.

Question 3: Do you have any comment on the proposed requirements for Non-qualified Minority-owned Properties? Please explain your view.

CompliancePlus agrees to a large extent with the proposed requirements for Non-qualified Minority-Owned Properties and the 10% cap on individual investments on Non-qualified Minority-Owned Properties, as this promotes diversification and lowers unsystematic risk.

However, based on the amendments to Chapter 7 of the REIT code, we have a few suggestions:

(a) Under 7.7D Note (2), instead of "generally expected that investments would also comply with the overarching principles set out above", the SFC should amend the phrase "generally expected" to a stronger word such as "should". Using the phrase "generally expected" might cause misconceptions that it is not necessary for REITs to follow such principles with regards to Non-qualified Minority-Owned Property investments. We believe that all of these overarching principles are applicable and the SFC should ensure compliance from REITs.

(b) Under 7.7D Note (3), in addition to providing the information required, REITs should distinguish between Qualified and Non-qualified Minority-owned properties. The SFC should also require further information to be disclosed for Non-qualified Minority-owned properties as they are inherently riskier. Thus, the SFC should provide a more detailed list of additional financial information to be required.

(c) Under 7.7D Notes (3), the SFC does not explicitly require REITs to disclose the financial information for each Non-qualified Minority-owned property in the annual and interim reports of the scheme. However, we believe that the financial information of Non-qualified Minority-owned properties should also be included because they represent their respective financial positions. Financial information is a key piece of information that investors should consider when making investment decisions. Even though there is a distinction between qualified and non-qualified, such important information should be disclosed by both types of minority-owned properties. This not only provides transparency to unitholders by ensuring that they have sufficient knowledge about their investments but also allows them to better protect their interests.

Question 4: Do you have any comment on the proposed disclosure and other requirements for investments in Minority-owned Properties?

CompliancePlus generally agrees that the proposed disclosure and other requirements for investments in Minority-owned Properties are adequate. Nonetheless, the SFC may need to consider whether more stringent disclosure requirements should be imposed on REITs. Having minimum disclosure requirements is important to ensure transparency among different stakeholders, but it

should be encouraged to disclose as much information as practicable to better protect the interests of unitholders.

To do so, the SFC should require REITs to disclose any material information and provide periodic updates to unitholders in the interim and annual reports of the scheme, similar to the safeguards in place for property development projects. Below are several suggestions that the SFC can consider or elaborate on in the consultation conclusion paper.

(a) Aside from the risks and potential impact on the REIT relating to the ownership structure in the property, there might be other risks surrounding Minority-owned properties. Since this proposal is relatively new, investing activities regarding Minority-owned properties will be inherently riskier due to the lack of historical performance and experience. Thus, the SFC should require REITs to disclose other risks and its impacts that are commensurate with its investment strategy and objectives. This can protect the interests of unitholders and ensure sound investment decision making.

(b) As the SFC is requiring all acquisitions of Minority-owned Properties to be announced, it should further elaborate on the details of the announcement. For example, the SFC should provide more guidelines on the timing, channel, and procedures for announcements to ensure that relevant stakeholders are properly notified.

CompliancePlus believes that these additional suggestions can provide more transparency and strengthen the regulatory framework for the Code on REITs.

Question 5: Do you agree with our proposal to align the diversification limit on the REIT's holdings of Relevant Investments issued by any single group of companies with the Single Investment Cap on Non-qualified Minority-owned Properties of 10% of GAV? Please explain your view.

CompliancePlus agrees with the proposal to align the diversification limit on the REIT's holdings of Relevant Investments issued by any single group of companies with the Single Investment Cap on Non-qualified Minority-owned Properties of 10% of GAV as this promotes diversification and lowers unsystematic risk.

Promotes Diversification and Lowers Unsystematic Risk

As a REIT, a REIT manager cannot diversify away from the systematic risk of the real estate market losing value. However, a REIT manager can diversify away from the unsystematic risk of individual properties by allocating the fund's assets into a diversified group of properties.

By increasing the Single Investment Cap on Non-qualified Minority-owned Properties to 10% of GAV, SFC effectively increases a REIT's ability to diversify its portfolio. This gives REIT managers more options to spread out their investments and thus reduce unsystematic risk. At the same time, diversification also helps to manage volatility and provide a more stable path for equitable growth and development.

By also limiting the Single Investment Cap on Non-qualified Minority-owned Properties to 10% of GAV, the SFC can prevent excessive diversification where a REIT over-allocates into Non-qualified Minority-owned Properties and ends up being exposed to higher volatilities and thus a higher potential for losses. As a result, by providing an increased option to diversify into Non-qualified Minority-owned Properties and limiting this diversification limit, the SFC can promote stable and equitable growth and development of the Hong Kong REIT market.

Amendment 2: Property Development for REITs

Question 6: Do you have any comment on the proposal to adjust the 10% GAV Cap and the safeguards imposed? Please explain your view

CompliancePlus is in agreement with the proposal to adjust the 10% GAV cap and the safeguards imposed. Allowing REITs to participate in the property development stage can broaden its options of acquisition targets and diversify their investment strategies. Therefore, adjusting the GAV cap gives more flexibility to REITs when making their investment decisions.

Enhance Global Competitiveness and Consistency with Foreign REIT Markets

This proposal is consistent with REIT markets in other major jurisdictions, such as Singapore and Malaysia. Singapore has increased the limit for property development to 25% of the REIT's total asset value, while Malaysia has allowed REITs to engage in property development up to 15% of the REIT's total asset value. This shows that other jurisdictions are moving towards greater flexibility within the

property development area, hence providing sound evidence that Hong Kong should follow suit. CompliancePlus believes that the SFC should move in this direction to assist REITs in their development of its portfolios and enhance its global competitiveness, given that it is in the best interest of its unitholders.

However, increasing the 10% GAV cap and allowing more flexibility is only likely to be of use to larger REITs. As smaller REITs may not have sufficient resources to invest in large-scale property development projects, the new proposal will be of limited utility to smaller REITs.

Comments on Safeguards and Requirements

Regarding the relevant safeguards and requirements, CompliancePlus generally agrees that they will provide adequate protection. It is essential that consultations with unitholders and trustees are carried out to ensure that they understand the investment, to make an informed decision, and give proper consent. However, we have a few comments and suggestions that are summarised below:

(a) Under clause 7.2A Notes (6), during the consultation phase, the SFC should further clarify and give examples of what consists of "material information" to ensure that the REIT will make adequate disclosures.

(b) The specifics on “unitholders’ approval” should be further defined. The SFC should further clarify what is deemed appropriate “unitholders’ approval”. CompliancePlus suggests that the SFC should require REITs to obtain at least a 50% majority vote for the investment to be made.

(c) The SFC can add a similar clause as with Minority-owned properties where a single property development investment may not exceed 10% of the GAV. Even if the REIT has a conservative investment strategy, if they have the option to invest in a single property development investment that exceeds 10% of their GAV, it may increase the risk profile of the REIT. Including this requirement will give REITs more flexibility for property development, while protecting REITs from exposing themselves to too much risk. The SFC should also clarify that property development projects are counted as a non-core investment and that the aggregate of all non-core investments may not exceed 25% of GAV.

Amendment 3: Borrowing Limit for REITs

Question 7: Do you have any comments on the proposed increase of the borrowing limit from 45% to 50%? Do you think a higher borrowing limit above 50% should be allowed? Please explain your view. If you think a higher borrowing limit should be allowed, what should be the appropriate limit and what other conditions or safeguards (if any) should be imposed?

CompliancePlus agrees with the proposed increase of the borrowing limit from 45% to 50% as it can assist REITs in portfolio growth and keep up with foreign jurisdictions.

Assist REITs in Portfolio Development

In general, the investments that REITs partake in require a lot of capital and financing. However, raising capital takes a long time and thus time is needed before REITs can obtain proper financing for new projects. Increasing the borrowing limit can allow REITs to obtain capital efficiently to facilitate their development.

Furthermore, increasing the borrowing limit can also allow REITs to secure more financing without diluting their value as they would not have to issue additional units. Lastly, increasing the borrowing limit can also encourage REITs to expand and resolve any worries they had about exceeding the original limit.

Enhance Global Competitiveness of Hong Kong in the REIT Market

Other foreign jurisdictions have improved the flexibility in borrowing for REITs. On April 16th, 2020, the borrowing limit for Singapore REITs was raised from 45 to 50%. By aligning the Hong Kong REIT market with foreign jurisdictions, the global competitiveness of Hong Kong REITs will improve. As Singapore's borrowing limit for REITs is capped at 50%, we believe that it is unnecessary to increase the limit in excess of 50%.

However, Japan has no gearing limit imposed on REITs with the condition that REITs are not allowed to partake in development activities. Even though Hong Kong's REIT market is similar to Singapore, other jurisdictions might have different regulations. Thus, to maintain competitiveness, the SFC should conduct regular reviews so that the Hong Kong REIT market can continue to flourish and outperform their competitors.

CompliancePlus has a few comments and suggestions on the proposed increase of the borrowing limit:

(a) CompliancePlus raises the possibility that increasing the borrowing limit would worsen the debt ratio of REITs. However, based on statistics of major REITs in Hong Kong, we believe that REIT managers are financially prudent and are unlikely to become over-leveraged in the long term. In 2019, Champion REIT had a gearing ratio of 18.6% and Link REIT had a gearing ratio of 10.7%, which are both well below the limit of 45%. Thus, it is highly unlikely that the debt ratio of REITs will deteriorate. This shows that Hong Kong REITs are already unwilling to increase their borrowing under the existing limit. By increasing the limit, the SFC can encourage them to do so. On the other hand, the low gearing ratios of REITs can also suggest that REITs do not need an increase in the borrowing limit. However, the low ratio might be due to a number of factors, thus, we believe that there is no harm in increasing the limit, and as this can act as an encouragement to REITs to increase their borrowing.

(b) Under 7.9 Notes (1), the SFC illustrated that no further borrowing is permitted if the limit is exceeded. However, we believe that it is quite vague, and the SFC should further specify how long would this restriction last. If no further borrowing is permitted for the rest of the REIT's existence, we believe that it might be too harsh as it can hinder the development and growth of the REIT market. Hence, we suggest that the SFC should impose a period where further borrowing will not be permitted.

(c) Under 7.9 Notes (1), if there is concern that the REIT will not be able to pay back its debts, we suggest that a possible limitation can be imposed: Any investments used with new leverage must be on conservative investments that generate rental income to hedge against the risk that the decrease in property values may result in the borrowing limit being exceeded. This might be better than prohibiting future borrowing as it still allows REITs to invest in certain investments.

CompliancePlus is positive that increasing the borrowing limit will assist the development of REITs under proper safeguards and requirements.

Amendment 4: Connected Party Transactions and Notifiable Transactions for REITs

Questions 8: Do you have any comments on the proposed amendments to the definition of "connected persons"? Please explain your view.

CompliancePlus generally agrees with the proposed amendments to the definition of "connected persons". We believe that the definition of "connected persons" is outlined clearly within 8.1 (a-h) in the new proposed code. The proposed amendments are also in line with overseas jurisdictions and HKEX listing rules. However, we have some comments on the proposed amendments:

Aligns with Overseas Jurisdictions

In Clause 55, it is proposed that "the Principal Valuer of a REIT and its affiliates" be removed as "connected persons" given the robust requirements for the Principal Valuer to be independent of the REIT. Being an independent party providing services to a REIT, the Principal Valuer has a vastly lower level of connectivity from that of the trustee, substantial holder, or management company of the scheme.

Therefore, the Principal Valuer and its affiliates should not be viewed as "connected persons. This is in line with REIT markets in other overseas jurisdictions as well. For example, the property valuer of a REIT listed in Singapore or Malaysia is not regarded as a "connected person" of the REIT. By not only aligning the requirements for REITs to HKEX's listing rules but also to foreign REIT markets, the SFC can further improve the global competitiveness of the Hong Kong REIT market.

Potential Technical Difficulties in Aligning REIT's Requirements

Section 8.1 of the proposed code gives a clear and strict guideline for individuals that are deemed "connected persons". However, 8.1 (h) states that a "person deemed to be connected by the Commission" is also included as "connected persons". While we understand that these individuals will be determined on a case-by-case basis, we believe that it would be practical to provide a more specific description to such individuals for affected REITs.

For example, the SFC can provide examples for a given scenario for a sample REIT either beneath section 8.1 (h), and or further clarify what this means in the Further Asked Questions ("FAQ") section. This can give REITs a clearer picture of what the SFC means by "connected persons. The SFC should also regularly update the FAQ when other technical difficulties regarding the alignment arise and

provide channels for REITs to consult them in case there are any difficulties or misunderstandings regarding the definition.

CompliancePlus believes that the clear definition outlined in the SFC's proposed code for REITs will provide a practical guide for REITs to follow, and these comments can further supplement that by clarifying any misunderstandings to ensure compliance by REITs.

Question 9: Do you agree with the proposal to align the connected party transactions and notifiable transaction requirements for REITs with the Listing Rules? Please set out your reasons.

CompliancePlus agrees with the proposal to align the connected party transactions and notifiable transaction requirements for REITs with the Listing Rules. Firstly, REITs are listed in the same stock market as listed companies, thus it would level the playing field for listed companies by subjecting REITs to the same requirements.

Secondly, imposing stringent requirements for REITs to disclose and announce such transactions is important to maintain transparency of the REIT and look after the interests of investors. However, we must also acknowledge the fact that REITs are fundamentally different from listed companies (e.g. different legal structures) and thus are also subject to different restrictions.

<u>Evens Out the Playing Field for Listing Companies</u>

Despite the large variety in the business practices and industries within listed companies of any stock exchange, their treatment is the same. Thus, by not imposing the same requirements and restrictions on them, REITs gain an unfair competitive advantage over listed companies.

Therefore, by aligning the requirements for connected party transactions and notifiable transactions with the Listing Rules, the SFC would be able to even out the playing field for listed companies.

<u>Protects Investors' Interests</u>

By aligning the connected party transactions and notifiable transaction requirements for REITs with the Listing Rules, REITs will be subject to stricter requirements regarding such transactions. Beyond

the above benefit of constructing a fair market for listed companies, this also protects the interests of investors by increasing the level of transparency.

As mentioned in our response to Question 2, if REITs partake in transactions that cause changes to the REIT's risk profile, the REIT may become inappropriate for investors whose risk tolerance, time horizon, and investment objective are incompatible with the new profile. By increasing the transparency of a REIT's transactions, an investor can now more accurately view whether or not the REIT is a good investment based on the investor's compatibility with the REIT.

This protects the investors' interests by allowing them to evaluate each REIT holistically. It is also optimal that all announcements and circulars issued should include the trustee's view on the subject matter. This takes into consideration all parties involved in a REIT and provides investors with additional information to make an informed decision on whether or not to buy, hold, or sell an investment.

REITs are Fundamentally Different and Should be Treated Differently

Although the argument that REITs should be subject to similar requirements as listed companies is sound, we must also acknowledge that REITs are fundamentally different from listed companies and thus may have difficulties.

A REIT is a trust, which is a very different legal structure with different restrictions from that of a listed company. For example, a REIT must pass on at least 90% of its taxable income to unitholders to enjoy tax benefits. While this is not a requirement, and listed companies have their methods to enjoy tax benefits, this can greatly limit a REIT's ability to grow as it cannot reinvest much of its income into the business without increasing tax expenditure.

REIT projects generally take a long time before being able to yield positive returns from inception. While other listed companies in the industries of biotech and pharmaceuticals also share the same burden of time, they are not subject to the same recurrent income requirement as REITs.

Due to such differences, CompliancePlus believes that more consultation and trials are needed to see whether this alignment can be executed properly without any difficulties. As we will detail in our response to Question 12, this is one of the reasons why we believe that a transitional period is necessary for a successful and smooth alignment of REIT requirements to the Listing Rules.

Question 10: Do you have any comments on the other proposed amendments to Chapter 8 and Chapter 10 of the REIT Code?

CompliancePlus generally agrees with the proposed amendments to Chapter 8 and Chapter 10 of the REIT Code. However, we have a few comments and suggestions that could enhance the clarity of the Code.

(a) We agree with Clause 8.7D and E as it can protect the interests of unitholders and enhance transparency among different parties. Regarding 8.7D, we believe that it is beneficial for announcements and circulars to set out the trustee's view on the transaction. This can reassure unitholders and provide them with reliable information so that they can make a well-informed decision. Regarding 8.7E, we believe that it is essential that constitutive documents should be published in the interim or annual report. This allows unitholders to access key information and ensures transparency.

(b) Under Clause 8.7A, the Code states that "All transactions carried out by or on behalf of the scheme shall be carried out at arm's length and on normal commercial terms". We suggest that "normal commercial terms" should be further defined. According to the HKEX Listing Rules Chapter 14A (8), "normal commercial terms" refer to terms which a party could obtain if the transaction were on arm's length basis or on terms no less favourable to the listed issuer than terms available to or from independent third parties. We believe that it is not clear enough if REITs rely on this definition. This is especially the case for newly formed REITs as it might be even harder for them to determine what constitutes as "normal commercial terms". As a result, CompliancePlus suggests that the SFC can further specify this in the FAQ section, including guidance on how to properly determine whether the terms are in line with the normal terms.

(c) Under Clause 8.7B and 8.7C, the Code states that the SFC has "the power to specify that an exemption will not apply to a particular transaction", and can "waive any requirements under this Chapter on a case-by-case basis, subject to any conditions that it may impose". We believe that these two clauses are too vague as it gives the ultimate decision making power to the SFC, which might generate concern among the REITs. Giving the SFC such powers might cause panic and confusion among REITs without appropriate guidelines. Thus, the SFC should specify more on the procedures and details of their decision making, as well as disclose

their reasoning behind their decision. This information can also help REITs to change their operations according to SFC regulations and prevent them from committing the same mistake again. In this way, trust and transparency between the SFC and the REITs can be maintained. CompliancePlus suggests that the SFC can further clarify these points in the FAQ section, to provide more specific conditions in which the SFC can make such decisions.

Other Amendments

Question 11: Do you have any comments on the proposed miscellaneous amendments? Please explain your view

CompliancePlus generally agrees with the proposed miscellaneous amendments. We believe that this section seeks to clarify and update certain operational procedures of REITs listed in Hong Kong which helps bring the code up to date with current practices and provide relevant guidance.

However, we do have some comments regarding the limitations on special purpose vehicles ("SPV") and the public float requirement.

Removing the Limitation on SPVs Reduces Risk

Through the removal of the previous limitation on the use of two layers of SPVs, the SFC can reduce any negative financial impact upon REITs and its unitholders when the REIT undertakes a risky venture. In providing increased flexibilities in investing in Minority-owned Properties and Property Development from Amendments 1 and 2, REITs will be able to assume greater risks by engaging in such investments.

Thus, the option to be able to use more than two layers of SPVs can allow REITs to isolate the risk of any investment in Minority-owned Properties or Property Development into a new SPV. Doing so will adequately protect REITs and its investors from bankruptcy, loan defaults, or other losses in the case of the project failing.

SPVs can Simplify the Process of a Sale

If a REIT wishes to sell a property that is involved in complex financial transactions and requires numerous permits to operate, using an SPV can simplify the process of a sale. Since an SPV has its own financial statements, it would be easier to track the property's income and expenses.

Additionally, the permits associated with the property are also stored in the SPV. Therefore, when it comes time to sell the property, a REIT can simply sell the SPV and the permits associated without needing to sign over the permits. This can greatly simplify a sale and allow a REIT to attract more potential buyers thereby without compromising on their price.

Danger in SPV Loopholes

At the same time, we must also acknowledge the accounting loopholes in the use of SPVs that can be exploited in a way that hides company debt. This was especially apparent in the 2001 Enron scandal when Enron transferred much of its stock into an SPV and took cash or a note in return. The SPV then used the stock it held for hedging assets which were on Enron's balance sheet. Enron also guaranteed the value of the SPV. Thus, when the value of the SPV decreased along with Enron's stock price, the guarantees were forced into play.

To prevent REITs from possibly exploiting SPVs to hide debt, the SFC should add additional requirements. For example, REITs should be required to disclose all of the financials of all SPVs it possesses and encourage potential investors to investigate these financials in addition to the REIT's financials. Since the SPV may mask crucial information from a REIT's financials, investors should undertake proper investigations to get a full view of the scheme's financial situation.

Public Float Requirement is Aligned with HKEX Requirements for Listed Companies

There is an inverse correlation between the size of a company's float and the volatility of the stock's price. This is because the greater the number of shares available for trade, the lower the volatility the stock will experience because it is harder a small number of shares to move the price.

Therefore, by imposing a public float requirement, the SFC can reduce the price volatility of REITs listed in Hong Kong. The HKEX also has a public float requirement of 25% on listed companies. Therefore, assigning a public float requirement also helps achieve the SFC's goal of aligning REITs with the requirements of listed companies in Hong Kong to achieve consistency within the listing rules.

Overall, this section clarifies and updates certain operational procedures of REITs listed in Hong Kong and helps to keep the code up to date with current practices. CompliancePlus believes that such amendments can help facilitate the development of the Hong Kong REIT market and increase its global competitiveness.

Implementation Timeline

Question 12: Do you have any comments on the proposed implementation timeline?

CompliancePlus understands the SFC's concern for the Code to take immediate effect upon gazettal due to price-sensitive information and the fast-paced nature of the market. Though we acknowledge this concern, we believe that a transitional period should still be in place to allow REITs to adjust and address any queries. We suggest a transitional period of 3-6 months to provide time for REITs to transition and adapt to the new REIT Code.

According to Clause 68 of the proposal, it specified that REIT managers may have to "ascertain whether any amendments would have to be made to the constitutive documents of their REITs before undertaking any investment pursuant to these proposals".

To avoid REITs from making mistakes and violating any regulations, a transitional period is needed so that they can properly consult relevant stakeholders and prepare for these changes. Other financial regulators have provided a transitional period when changing their regimes.

Conclusion

CompliancePlus welcomes the proposed amendments to the Code on Real Estate Investment Trusts as these amendments can increase the global competitiveness of the Hong Kong REIT market by facilitating further development of their portfolios.

Regarding the proposed amendments to investing in minority-owned properties, Complianceplus is positive that these amendments can increase acquisition options, enhance global competitiveness, and decrease the risk of investment losses for REITs.

We also agree with the overarching principles and specific conditions, but the SFC should encourage additional information to be disclosed and provide more guidance to enhance transparency. Regarding Non-qualified Minority-owned Properties, we agree with the 10% cap on individual investments, However, we suggest that the SFC require REITs to disclose more information to protect unitholders. Lastly, we agree with the proposal to align the diversification limit as it promotes diversification and lowers unsystematic risk.

Regarding the proposed amendments to investing in property development, CompliancePlus believes that the proposal to adjust the 10% GAV cap and the safeguards imposed can broaden a REIT's options of acquisition targets and diversify their investment decisions. In doing so, the SFC can enhance the global competitiveness of the Hong Kong REIT market by aligning with foreign REIT markets. At the same time, we have made suggestions to clarify certain terms in the code to make sure that the safeguards can protect the unitholders' best interests.

Regarding the proposed amendments to the borrowing limit, CompliancePlus agrees with the proposed increase as it can assist REITs in portfolio growth and allow them to keep up with foreign jurisdictions. We also believe that the risk of REITs being over-leveraged is relatively low and that the increase can encourage REITs to borrow. However, we believe that the SFC can adjust their sanction where a REIT exceeds the borrowing limit due only to a decrease in property values to minimize its financial hindrance to REITs.

Regarding the proposed amendments to connected party transactions and notifiable party transactions, CompliancePlus generally agrees with the proposed amendments as these would align the REIT market with the requirements of the listing rules, are in line with overseas jurisdictions, and protect investors' interests. However, there are potential technical difficulties in making this alignment smooth due to the inherent restrictions that REITs are subject to. Therefore, the SFC should conduct further consultation and trials to make this transition smooth.

Regarding the proposed miscellaneous amendments, CompliancePlus generally agrees with the proposal as they seek to keep the operational procedure of Hong Kong REITs up to date with current practices and provide relevant guidance. However, we caution the potential of misuse regarding special purpose vehicles and suggest additional disclosure requirements to be imposed if REITs choose to exercise the ability to use more than two layers of SPVs.

CompliancePlus hopes that the SFC can consider our comments and suggestions, to provide what's best for the development of REITs. We also hope that a transitional period can be established so that REITs will have sufficient time to adjust to the new amendments.

-END-