CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

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

Josephine Chung
Director, CompliancePlus Consulting Limited

Tom Ng, Research Assistant
February 2014

For enquiries 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 by the SFC.

Introduction

Investor protection in Hong Kong is achieved through two major means. One is product authorisation; the other is intermediary regulation. When it comes to Real Estate Investment Trusts ("REITs"), the former is primarily governed by the Code on REITs. The latter is primarily embodied in the Code of Conduct for Persons Licensed by or Registered with the SFC (which is applicable to all licensed and registered persons).

The SFC now proposes to amend the Code on REITs to allow REITs to (1) invest in properties under development and (2) invest in financial instruments. We welcome the first proposal but disagree with the second proposal. But before we move on to discuss the merits of these two changes, some preliminary observation has to be made.

SFC's discretion to relax the Code

REITs are usually "collective investment schemes" within the meaning of the Securities and Futures Ordinance ("SFO") (Cap.571). As such, the SFC has the power to authorise REITs and to allow them to advertise to the general public: see sections 104 and 105 of the SFO. The Code on REITs contains the criteria for obtaining the relevant authorisation. To this end, the Code on REITs should be consistent with the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products ("the SFC Handbook"), which also deals with the issue of authorisation. Favouritism is to be avoided.

This leads to our first suggestion to the SFC's proposal. The SFC intends to add the following provision to the explanation notes to the Code on REITs:

> *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.*

There is nothing inherently improper about giving the SFC the discretion to modify or relax the authorisation requirements in particular circumstances. The problem, however, is that such discretion is only given when it comes to REITs or Investment Linked Assurance Schemes ("ILAS"): see the ILAS Code in the SFC Handbook. The SFC must articulate why similar discretion has not been extended to other investment products, such as mutual funds and unit trusts (see the Code on Unit Trusts and Mutual Funds in the SFC Handbook). A better approach is to extend the discretion to all forms of investment schemes.

Moreover, the SFC should not exercise the discretion if this would "compromise" the General Principles outlined in the Code on REITs. This is consistent with the approach that the SFC has taken over the years, as articulated in the FAQ on REITs (Question 12):

> *The SFC will only grant waivers in exceptional circumstances specific to a REIT, bearing in mind that the SFC will not consider waiver applications that compromise any of the General Principles. Furthermore, costs alone are not sufficient justification for any waiver from compliance with the REIT Code. Each application for waiver will be considered on its own merits and an applicant should provide the SFC with clear and cogent reasons in support of the application for waiver, and demonstrate to the SFC that there are sufficient mechanisms in place to ensure that investors' interests will not be compromised.*

A similar approach should be adopted. Preferably, the SFC should also issue a FAQ on how would the discretion be exercised and also the SFC should disclose to the public by uploading details of such waiver to SFC website as to what waiver has been granted and granted to which REITS as well for public information. Disclosure similar to waiver granted relating to licensing and FRR rules should be adopted.

We now consider the two proposals made and the seven questions raised by the SFC.

Question 1: Do you consider that flexibility in respect of property development investments and related activities should be introduced for REITs?

In relation to investing in properties under development, it must be shown that the REITs do not have the intention to sell the properties within a short period of time. Otherwise the REITs would be merely speculating. To this end, the two years minimum holding period may not be long enough in light of the growing speculation in the Hong Kong non-residential properties market and the investment cycle for property development, a longer holding period is to be preferred.

There is also one drafting point. The relevant provision in the Code on REITs provides:

> *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.*

In the proposal, the SFC proposes to add the following "note" to the aforesaid provision:

> *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.*

It is not immediately clear whether the exception to the two years holding period applies to property development activities. If that is not the case, the "note" should clearly say so.

In relation to investment in vacant land, in principle REITs should only be allowed to invest if the purchase of the land would lead to a property development project. The

SFC adopts a similar approach, although more guidance as to how can one demonstrate that the land is to be used for such development should be issued by the SFC. Concrete rules can also be laid down, e.g. the land must not be left vacant for more than a certain period of time.

Question 2: Do you consider that the 10% GAV Cap is set as an appropriate threshold?

We agree that the existing 10% cap on uncompleted units can also be applicable to properties under development and vacant land.

There is however one important point that does not emerge too clearly in the consultation paper. The existing requirement is that the value of the uncompleted units cannot exceed 10% of the total value at the time of acquisition. This requirement is replicated in the present SFC proposal.

However there is one more new requirement, namely that the value of uncompleted units and properties under development should not exceed 10% of the total value at all times.

This can cause difficulties to the REITs, in that the total value of the REITs may decrease if the other assets held by the REITs depreciate. In this case the value of the uncompleted units and properties under development may exceed 10% (even if the value of those assets was below 10% at the time of acquisition). It is not immediately clear what the REITs can do: the REITs may not be allowed to dispose of the properties to "re-balance" in light of the two years minimum holding period requirement.

The Monetary Authority of Singapore, recognising this problem, provides an exception to the 10% cap in Appendix 6 to the Code on Collective Investment Schemes:

> *7.4 The investment restrictions and requirements in paragraphs 7.1(d) and (e) are applicable at the time the transactions are entered into. A property fund is not required to divest any assets that breach the restrictions or requirements if such*

breaches were a result of:

a) the appreciation or depreciation of the value of the property fund's assets …

Similar provision should also be included.

Alternatively, in our view, the new 75% requirement (i.e. at least 75% of the gross asset value shall be invested in real estates that generate recurrent rental income at all times) provides a sufficient safeguard to investors. There is no need to impose an additional 10% requirement that is applicable at all times.

Nevertheless, we agree that REITs should be alive to the danger of exceeding the 10% in case the development costs increase, and we agree with the SFC that sufficient buffer must be provided.

Question 3: Do you have any comments on how the Property Development Costs should be calculated?

We disagree that the cost should be calculated upfront. The usual accounting principle is that expenses are to be recognised when they are incurred. Moreover, calculating costs upfront may discourage multiple acquisitions within a particular period of time.

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?

We agree that investment in properties under development should be disclosed to the unitholders pursuant to paragraph 10.3.

In addition to the example given by the SFC, we believe that paragraph 10.3 should also include the situation in which a REIT disposes of the developed properties.

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?

As stated above, we believe that a longer minimum holding period may be necessary.

Question 6: Do you have any comments on the proposed scope of the Relevant Investments and the proposed Maximum Cap?

The overriding requirement is that at all times 75% of the total value must be invested in real estates generating rental income. In other words, a REIT can invest up to 25% in other assets.

Assuming that the REIT makes no investment in uncompleted units or properties under development, it can invest up to 25% in financial instruments. This represents quite a large proportion of the funds owned by the REIT. This may twist the genuine nature of REIT of investing into properties and may increase volatility of REIT as well that may not be aware to investing public. In addition, the fund managers of a REIT may not have the same investment capabilities of investing into other financial instruments which are two different investment universes.

We believe that a better approach is to allow a REIT to invest up to 15% of its funds (at all times) in financial instruments. In other words, the 10% cap relating to uncompleted units and properties under development cannot be transferred.

A similar 15% cap is applicable to unit trusts and mutual funds when it comes to unlisted securities: see paragraph 7.3 of the Code on Unit Trusts and Mutual Funds in the SFC Handbook.

The 15% cap can also ensure that the REITs would not adversely affect the mutual funds market. Mutual funds are, after all, prohibited from investing in real estates: see paragraph 7.14 of the Code on Unit Trusts and Mutual Funds in the SFC Handbook.

We emphasise that the Monetary Authority of Singapore adopts a similar approach, imposing an income cap (see Appendix 6 to the Code on Collective Investment Schemes):

7.2 A property fund should not derive more than 10% of its revenue from sources other than:

a) rental payments from the tenants of the real estate held by the property fund; or

b) interest, dividends, and other similar payments from SPVs and other permissible investments of the property fund.

The expected proportion of revenue from these sources should be fairly stable and not subject to significant fluctuations. If this requirement is breached, the manager should not take any action that would increase the extent of the breach.

Thus it makes sense to ensure that the REITs would not invest too much in the financial market and such investment flexibility should also be for portfolio risk management or hedge fund purpose and should be used for generating income stream for REITS.

In addition, we suggest introducing the following measures to address risks arising from this proposal:-

(1) inserting a key risk disclosure statement in the REIT marketing materials that up to certain percentage will be invested into other financial instrument

(2) If a fund manager wants to exercise this investment discretion of investing into other financial instrument, they should provide information about their profile and investment experience to demonstrate that they possess certain years of experience in managing other financial instrument as well.

Question 7: What other safeguards do you consider appropriate to be put in place corresponding to the proposal to allow for the Relevant Investments?

There is again one drafting point. The SFC proposes that:

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

"Relevant Investments" includes locally listed securities and property funds. The SFC should clarify whether securities held indirectly through property funds also count for the purpose of determining whether the 5% threshold is reached.

Appendix B to the Code on REITs (disclosure to be made in the offering documents) should also be amended and REITs should disclose their intended investment in the financial market.

Similarly, Appendix C (financial statement) may also have to be amended in light of the REITs' ability to invest in the financial market.

Conclusion

The SFC's proposal to allow REITs to invest in properties under development is to be welcomed. On the other hand, REITs should only be allowed to invest up to 15% in financial instruments. More stringent regulatory requirements should also be imposed as suggested above.

END