



By email <[reitsconsultation@sfc.hk](mailto:reitsconsultation@sfc.hk)> and by post

26 February 2014

Our Ref.: C/CFC, M93167

The Securities and Futures Commission  
35<sup>th</sup> Floor, Cheung Kong Centre  
2 Queen's Road Central  
Hong Kong

Dear Sirs,

**[Consultation on Amendments to the Code on Real Estate Investment Trusts](#)**

The Corporate Finance Committee of the Hong Kong Institute of Certified Public Accountants ("the Institute") has considered the above consultation paper, which seeks views and comments on the proposed amendments to the Code on Real Estate Investment Trusts ("REITs"). Our comments on the proposals are provided below.

We generally support the proposals to introduce greater flexibility to the permissible investment scope for REITs, within reasonable bounds. After more than ten years, it is appropriate to take stock of the development of the REIT market and the regulatory framework in Hong Kong and to consider how the market might be encouraged and expanded and, where appropriate, to look at comparative developments in other markets overseas.

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

In principle, we support the proposal to allow REITs to undertake property development investments and related activities, subject to a maximum threshold of 10% of the REIT's gross asset value ("GAV"). Allowing REITs to undertake property development will enable them to design assets to suit their particular needs and, potentially, obtain a better return. We consider that the 10% GAV cap, which, we note, is inclusive of the acquisition of uncompleted units (as indicated under note (2) to paragraph 7.1 of the proposed revised REIT Code), appears to be an appropriate threshold.

As regards the more detailed and technical issues related to this proposal, we should also like to make a few points.

In relation to calculating the 10% GAV, the point at which a particular development is considered to have been completed and no longer needs to be included in the calculation should be made clear.

In calculating investments in properties under development and property development activities ("Property Development Costs"), we note that it is proposed to include the total project costs borne and to be borne by the REIT (inclusive of the costs for the acquisition of land, if any, and the development or construction costs of the project), as indicated under paragraph 16 of the consultation paper. In order to avoid any ambiguity and inconsistency with the amount to be recognised in the REIT's financial statements, we recommend that reference be made to Hong Kong Accounting Standard ("HKAS")

40 *Investment Property* and HKAS 23 *Borrowing Costs*, as appropriate, for the purpose of determining the various costs to be taken into account in the calculation of the Property Development Costs.

Note (2) to the proposed paragraph 7.2A of the Code states that, "*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.*"

However, the consultation paper does not indicate what remedial action should be taken by a REIT and its management company were the aggregate amount of the contract value in relation to acquisition of uncompleted units, together with the value of the investments in property development projects and related activities, to exceed the 10% GAV cap, and whether there would be consequences for the management company. We recommend that the REIT Code clarify how such situations would be dealt with.

Note (5) to the proposed paragraph 7.2A states that, "*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.*"

It is suggested that the Code should set out in more detail the relevant competence and expertise required of the technical personnel, as has been done, for example, under chapter 18 of the Listing Rules, which prescribes the qualifications, experience and competency requirements for a "competent person" and a "competent evaluator" in relation to the listing of mineral companies.

## **B) Proposal for introducing flexibility in respect of investments in financial instruments**

We consider that some flexibility should be allowed for REIT managers to undertake investments in financial instruments, so that they can better manage the REIT's cash position. However, we believe that this flexibility should be kept within reasonable bounds, bearing in mind the original characteristics of REITs to provide a vehicle for relatively stable, income-producing investments in property, derived primarily from rentals. The existing proposal, if not subject to further qualifications, could result in a significant part of the REITs assets being invested in higher risk, non-property-related financial instruments, to the ultimate detriment of small retail investors. For this reason we would suggest that consideration be given to a more gradual approach in terms of opening the door to investment in financial instruments.

We note the general conditions that it is proposed to impose that, for example, such investments should be sufficiently liquid, could be readily acquired/ disposed of under normal market conditions, in the absence of trading restrictions, and have transparent pricing; that the value of investments issued by any single group of companies may not exceed 5% of the GAV of the REIT; and that at least 75% of the GAV of a REIT must be invested in real estate that generates recurrent rental income at all times.

However, permitting, in principle, up to 25% of a REIT's GAV to be invested in the categories of financial instruments listed in paragraph 35 of the consultation paper (assuming no investment in property development projects and uncompleted units, and no other miscellaneous holdings, etc.) could vary the risk profile and character of a REIT significantly. If an aggressive fund manager were to invest in speculative, high-risk instruments, it would be possible for a substantial part of a year's dividend to be



depleted on a holding of, e.g., 5% of the REIT's GAV in an investment. This could have a big impact on small retail investors, who may rely on a stable income stream.

In order to strike a better balance between making available a broader range of investment options on the one hand, and maintaining a REIT's recurrent income generating profile and protecting investors, on the other, we suggest that further consideration be given as to whether a lower ceiling than 25% of GAV should be set for investment in financial instruments. One option would be to set a separate limit for investment in financial instruments, as proposed for property development activities; for example, to specify that, within the limit of 25% of a REIT's GAV that may be allocated to investments other than real estate that generates recurrent rental income, up to 15% of GAV may be invested in financial instruments and 10% GAV in property development projects, the acquisition of uncompleted units and related activities.

Secondly, we would recommend that additional parameters be introduced in respect of the "Relevant Investments" in which REITs are allowed to invest. This could include, for example, a requirement that debt securities be investment grade and that securities listed on the Hong Kong stock exchange, or other internationally recognised stock exchanges, be index securities. In addition, the definition of "government and public securities" should not extend to, e.g., investments in state-owned enterprises of local governments in less developed regions.

As regards the condition that at least 75% of the GAV of a REIT must be invested in real estate that generates recurrent rental income at all times, it should be clarified that this would not preclude the periodic refurbishment or renovation of properties within the 75% holding, even though this could result in some partial or short-term suspension of rental income.

#### **Miscellaneous amendments**

We agree with the proposed technical amendment to add a paragraph in the "Explanatory Notes" section of the REIT Code enabling the SFC to modify or relax the application of a requirement in the Code if it considers that, in particular circumstances, strict application of the requirement would operate in an unduly burdensome or unnecessarily restrictive manner. As noted in paragraph 49 of the consultation paper, this amendment would maintain consistency with other codes and guidelines issued by the SFC and is in line with the SFC's regulatory approach.

If you have any questions on this submission or wish to discuss it further, please contact me at the Institute on 2287 7084.

Yours faithfully,

Peter Tisman  
Director, Specialist Practices

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