Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email (reitsconsultation2020@sfc.hk)

10 August 2020

Our Ref.: C/CFAP, M126892

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

Dear Sirs,

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

The Hong Kong Institute of CPAs' Corporate Finance Advisory Panel has considered the Consultation Paper on Proposed Amendments to the Code on Real Estate Investment Trusts ("CP") and, in general, supports the Securities and Futures Commission ("SFC")'s proposed amendments to the Code on Real Estate Investment Trusts ("REITs"). We agree that there may be scope for further flexibility to be given to REITs in terms of the types of investments in which they should be permitted to invest, in order to maintain Hong Kong's competitiveness as an international financial centre, while preserving the fundamental nature of REITs, which is based around generating recurrent rental income.

We would like to raise a few points for consideration, as further explained below.

Minority holdings

Q2 - Do you consider that the 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.

As regards the criteria for allowing minority holdings in properties (under 7.7A-C of the Code on REITs ("Code")), where a minority holding is a "Qualified Minority-owned Property", it may be excluded from the maximum 25% cap on non-recurrent-income-generating real estate and be counted towards the 75% core investments of a REIT (see 7.7C). However, certain "overarching principles" and "specific conditions" need to be met in order to be qualified. The specific conditions include a requirement, under specific condition (h)(ii), that certain veto rights over key matters be included in the joint ownership agreement, memorandum and articles of association and/or constitutive documents.

This is an important safeguard measure, especially for protecting the interests of minority unitholders, as indicated in paragraph 21 of the CP, which states:

"The principles and conditions include veto rights over some key matters involving the properties, the requirement that at least 75% of the GAV [gross asset value] of the underlying assets must be invested in real estate which generates recurrent rental

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income at all times….These principles and conditions seek to ensure that the Qualified Minority-owned Properties are income generating and that the REIT can maintain proportionate control."

We note, however, the use of the word "should" in the relevant condition, i.e., 7.7C (h) of the marked-up proposed changes to the REIT Code, which appears to make this particular condition less of an imperative than conditions 7.7C(f) and (g), where the word "shall" is used (see the Appendix). Conditions (f) and (g) relate, respectively, to receiving financial and operational information and having proportionate board representation (where applicable). While there may be reasons for this difference (e.g., because constitutive documents are already in existence before a REIT invests and it may not be straightforward to make the necessary changes), if a REIT does not have a veto over some or all of the items in specific condition (h), this would tend to weaken the safeguards for unitholders. Under the circumstances, the SFC should clarify how it would deal with such situations and when a Minority-owned Property would be regarded as a Qualified Minority-owned Property and when it would not, if, for example, REIT had a veto over some of items under specific condition (h)(ii) but not others.

Under overarching principle (e), it should be made clear that the REIT manager may also manage the Minority-owned Properties, which would be in the interests of unitholders, otherwise additional management fees would be payable to a third party management company or the joint venture partner.

Property development

Q6 - Do you have any comment on the proposal to adjust the 10% GAV Cap and the safeguards imposed? Please explain your view.

In paragraphs 35 and 36 of the CP, it is noted that the existing limit on Hong Kong REITs' investments in property development projects may be adjusted to facilitate the long-term growth of the Hong Kong REIT market. Hence, it is proposed that the existing 10% GAV cap may be exceeded if specific unitholders' approval can be obtained. In addition, the increase must be permissible under the REIT's trust deed and the trustee's prior consent must be obtained. Paragraph 38 of the CP states:

The additional unitholders' approval required to exceed the 10% GAV Cap, the Maximum Cap on total Non-core investments together with all existing governance and disclosure requirements applicable to investments in property development projects are considered appropriate safeguards for investor protection purposes.

We generally agree with this proposal, given that a minimum threshold of 75% of a REIT's GAV must continue to be invested in recurrent-income-generating real estate. However, as an additional minority unitholder protection safeguard, consideration could be given to requiring the resolution to give approval to exceed the 10% GAV threshold to be by means of an independent unitholders' vote.

Connected party transactions and notifiable transactions

Q9 - Do you agree with the proposal to align the connected party transactions and notifiable transactions requirements for REITs with the Listing Rules? Please set out your reasons.

Q10 - Do you have any comments on the other proposed amendments to Chapter 8 and Chapter 10 of the REIT Code?

Paragraph 50 of the CP indicates that the REIT Code requirements for connected party transactions and notifiable transactions should be aligned with the Listing Rules as much as practicable. In principle, we support this approach.

At the same time, we note that the SFC may exercise its discretion to waive any requirements in relation to connected party transactions, on a case-by-case basis, subject to any conditions that it may impose (e.g., 8.7C and 10.10D of the proposed amendments to the REIT Code). Such, apparently unfettered discretion, could create uncertainty and lead to inconsistencies. We would suggest, therefore, that further guidance be provided as to the circumstances under which the SFC would exercise this discretion. This would provide greater clarity for REITs and investors.

Other comments

Regarding proposed REIT Code amendment 7.2C(c), the scope of "other ancillary investments" may need to be clarified, as there are no clear rules or guidelines under the REIT Code.

In relation to the application of the Listing Rules to REITs, several of the "Notes" in the proposed REIT Code amendments contain wording suggesting that reference should be made to the requirements applicable to listed companies, "to the extent appropriate and practicable" (e.g., 8.1A, 10.5 (Note (1)), 10.8, 10.9). The effect of this wording is not clear. Could be taken to imply that, for example, in appropriate circumstances, certain de minimis exemptions, or a materiality test, could be applied, or where full compliance with certain detailed disclosure requirements would be very burdensome for a REIT, that there might some latitude. This needs to be further explained.

Should you have any questions on this submission, please feel free to contact me at the Institute on 2287 7084 or peter@hkicpa.org.hk.

Yours faithfully,

Peter Tisman
Director, Advocacy and Practice Development

PMT/NCL/pk

Encl.

Appendix

Extract on proposed amendments to the REIT Code

Chapter 7: Investment Limitations and Dividend Policy

7.7C – Where a Minority-owned Property can satisfy the following overarching principles and specific conditions (a "Qualified Minority-Owned Property"), it may be excluded from the calculation of the Maximum Cap under 7.2C subject to the Commission's approval.

Specific conditions

(f) The scheme **shall** have right to receive and obtain the financial and operational information of the jointly owned property.

(g) Where applicable, the scheme **shall** have no less than proportionate board representation.

(h) The joint ownership agreement, memorandum and articles of association and/or constitutive documents **should** include:

(i) A specified minimum percentage of annual distributable income will be distributed and the scheme should be entitled to receive at least its pro rata share of such distributions

Note: it is generally expected that the specified minimum percentage shall not be less than majority of the annual distributable income

(ii) veto rights over key matters, including:

(a) amendment of the joint ownership agreement, memorandum and articles of association or other constitutive documents;
(b) winding up or dissolution;
(c) cessation or change of the business;
(d) entering into any material transactions that are not in the ordinary and usual course of business or mergers;
(e) changes to dividend distribution policy;
(f) changes to equity capital structure;
(g) incurring of borrowings;
(h) creation of security over the assets;
(i) issue of securities or financial derivative instruments; and
(j) major acquisition, transfer or disposal of the assets; and

(iii) a dispute resolution mechanism between the scheme and the other joint owner(s).

[*N.B. Emphasis added in (f) – (h) above*]