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Hong Kong Securities and Futures Commission Consults Public on Proposed REIT Code Amendments

Recognizing the recurrent income generating product nature, the SFC may lift some restrictions on investment scope for Hong Kong listed REITs.

On 27 January 2014, the Securities and Futures Commission (SFC) commenced a one-month consultation on proposed amendments to the Code on Real Estate Investment Trusts (REIT Code). The purpose of the amendment exercise is to introduce greater flexibility in the investment scope of real estate investment trusts (REITs) listed in Hong Kong.

Background

Following extensive soft consultations with various industry participants and the SFC Committee on REITs and taking into account the discussions and developments in comparable overseas jurisdictions, the SFC considers now an appropriate time to revisit some investment restrictions in the REIT Code.

In November 2013, the Hong Kong Financial Services Development Council issued six research papers, including one entitled "Developing Hong Kong as a Capital Formation Centre for Real Estate Investment Trusts" (FSDC Paper), with the aim of strengthening Hong Kong's position as the pre-eminent international financial center and enhancing the development of the local financial services industry. The FSDC Paper prompted the review of the current REIT regulatory regime and proposed detailed modification to the existing REIT Code. The SFC consultation paper largely addresses the matters raised in the FSDC Paper.

Key proposals

The proposals in the SFC consultation paper seek to reasonably liberalize the investment scope of Hong Kong listed REITs by allowing (i) investment in properties under development or engaging in property development activities and (ii) investment in financial instruments, each subject to detailed threshold limits.

Investment in properties under development or engaging in property development activities

To ensure the fundamental characteristics of REITs as recurrent rental income generating vehicles, the existing REIT Code constrains the portfolio of a REIT so that the contract value of uncompleted properties under development shall not exceed 10 percent of the total net asset value of the REIT at the time of acquisition. A REIT is also prohibited from investing in vacant land or participating in property development activities (with the exclusion of refurbishment, retrofitting or renovations).

In line with the recent development in comparable jurisdictions and in response to various comments and enquiries from industry participants, the SFC proposes to revise the existing investment restrictions under the REIT Code. The revisions would allow REITs to undertake property development investment and related activities, subject to a ceiling of 10 percent of the REIT's gross asset value. In other words, the aggregate of all investments in (i) properties under development and property development activities undertaken by a REIT, calculated on an "at cost" basis cumulatively and (ii) the acquisition of uncompleted units in a building which is unoccupied and non-income generating or in the course of substantial development, redevelopment or refurbishment, shall not exceed 10 percent of the REIT's gross asset value.

While pure hoarding or speculative trading of vacant land is still viewed as inconsistent with the product nature of a REIT, the SFC is prepared to allow acquisition of vacant land provided that the REIT manager can demonstrate that such acquisition is part-and-parcel to a property development project within the investment objective or policy of the REIT — subject to the ceiling of 10 percent gross asset value of the REIT. The principle of a minimum holding period under the REIT Code will continue to apply and investments in the REIT's property development projects shall be held for at least two years from the completion of such properties.

Investments in financial instruments

While the existing REIT Code requires that a REIT shall only invest in real estate, the proposed amendments seek to introduce flexibility for REITs to invest in certain financial instruments other than real estate (including listed securities, unlisted debt securities, government and other public securities, and local or overseas property funds) provided that all of the following apply:

- The value of a REIT's holding of the financial instruments issued by any single group of companies may not exceed five percent of the gross asset value of the REIT (the concentration test).
- The financial instruments should be sufficiently liquid and could be readily acquired/disposed of under normal market conditions and in the absence of trading restrictions with transparent pricing (the liquidity test).
- At least 75 percent of the gross asset value of a REIT shall be invested in real estate that generates recurrent rental income at all times (the gross asset value test).

Responsibilities and duties of REIT manager

The additional flexibility introduced by the proposed amendments is not intended to materially affect the primary nature and the expected risk profile of a REIT. Under the amended code provisions, before making any investment decisions involving property development projects and financial instruments, the REIT manager, as a fiduciary, shall ensure that the investments are in the best interest of the unitholders. The REIT manager must have sufficient and appropriate skills, resources, risk management processes and controls in place to carefully assess the investment opportunities and to manage and monitor the investments and any associated risks. The proposed amendments also include detailed disclosure, reporting and unitholders' approval requirements (as applicable).

Other issues

The SFC consultation paper briefly discussed some other proposals contained in the FSDC Paper:

Profits tax

In response to the proposal in the FSDC Paper relating to the removal of profits tax on REITs, the SFC pointed out that unlike other jurisdictions, no tax is currently levied at the individual unitholder level on dividends or capital gains in Hong Kong. So removing the profits tax could result in Hong Kong REITs becoming completely tax-free. The government will need to determine if this would resonate well within Hong Kong's overall tax structure.

Companies Ordinance

The SFC noted the proposal in the FSDC Paper extends the compulsory acquisition and scheme of arrangement provisions under the Companies Ordinance to REITs, an extension which would require a legislative change. The SFC also affirmed that, with the extension of the Codes on Takeovers and Mergers and Share Repurchases (Takeovers Code) to REITs, REIT unitholders enjoy the same protection as shareholders of a listed company in takeovers, mergers and acquisitions. More specifically, privatizing REITs may be achieved by way of assets disposal followed by a delisting (provided compliance with the Takeovers Code).

Next steps

The SFC will release the consultation conclusions as soon as practicable after the end of the one-month consultation period (ending on 26 February 2014). Industry participants and professional advisers are encouraged to provide input and feedback to the proposed amendments to the REIT Code. The Hong Kong market expects to see the SFC striking a good balance between supporting market development and product innovation on the one hand and upholding investor protection on the other.

The SFC Consultation Paper can be downloaded via:
http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/doc?refNo=14CP2

The FSDC Paper can be downloaded via:
http://www.fsdc.org.hk/en/publications/2013

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Michael Liu
michael.liu@lw.com
+852 2912.2688
Hong Kong

Cathy Yeung
cathy.yeung@lw.com
+852.2912.2622
Hong Kong

Simon Berry
simon.berry@lw.com
+852.2912.2685
Hong Kong

Stephen Chan
stephen.chan@lw.com
+852.2912.2625
Hong Kong

Carmen Guo
carmen.guo@lw.com
+852.2912.2631
Hong Kong
