For discussion
on 7 January 2019

Legislative Council Panel on Financial Affairs

Implementation of the Securities and Futures Commission's Code on Real Estate Investment Trusts

PURPOSE

This paper briefs Members on the implementation of the Code on Real Estate Investment Trusts ("REIT Code") by the Securities and Futures Commission ("SFC").

BACKGROUND

2. A Real Estate Investment Trust ("REIT") is a collective investment scheme constituted as a trust that invests primarily in real estate with an aim to provide returns derived from recurrent rental income of the real estate (e.g. shopping malls, offices and hotels) to investors. REITs offer retail investors the chance to participate, by committing a relatively small investment amount, in property holding and investment managed by professional real estate managers. An investor can through a REIT gain investment exposure to large-scale income-generating real estate in a more cost effective manner. A REIT has to appoint a management company with a Type 9 (asset management) licence issued by the SFC to manage the scheme.

3. Since the conception of REITs in about the 1960s abroad, REITs had gained increasing popularity and importance in overseas securities markets[1] in the 1990s and early 2000s. To allow Hong Kong investors to have access to a wider range of investment products, the SFC introduced a regulatory regime for REITs in Hong Kong through the promulgation of

[1] Japan, Singapore, Australia and the United States are examples of overseas jurisdictions with an active REIT market.

the REIT Code[2] in 2003 following a public consultation. The REIT Code sets out the requirements on the management and product structure of REITs with a view to promoting market development while safeguarding investor interests. In drawing up the REIT Code, the SFC has drawn reference to the principles developed by the International Organization of Securities Commissions and other relevant overseas regulatory practices. The REIT Code was developed for and applies equally to all REITs authorised or seeking authorisation by the SFC.

4. A REIT has to be authorised by the SFC in accordance with the requirements as set out in the REIT Code (see paragraphs 6 below for details). A SFC-authorised REIT can be sold to the public and must be listed on the Stock Exchange of Hong Kong ("SEHK").

5. The first Hong Kong REIT was launched in 2005. As at 31 October 2018, there were 10 REITs open for trading on the SEHK[3]. Between end-2005 and end-2017, the market capitalisation of REITs in Hong Kong has grown by over six times. It went up from approximately \$38 billion to \$277 billion. As at end of 2017, Hong Kong REITs ranked fourth in the Asia-Pacific region in terms of market capitalisation. The performance of Hong Kong REITs has also marked significant growth over the years. The Hang Seng REIT Index has gone up by 147% from its launch in November 2005 to end-September 2018. It has outperformed the Hang Seng Index which grew by 84% during the same period.

IMPLEMENTATION OF THE REIT CODE

6. Under the REIT Code, a SFC-authorised REIT must –

(a) have dedicated investments in real estate that generate recurrent rental income (i.e. at least 75% of the REIT's gross asset value shall be invested in such real estate at all times).

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2 A copy of the latest version (August 2014) of the REIT Code can be found at https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-on-real-estate-investment-trusts/Code%20on%20Real%20Estate%20Investment%20Trusts.pdf.

3 They are Link REIT, Spring REIT, Yuexiu REIT, Hui Xian REIT, Champion REIT, Regal REIT, Fortune REIT, Sunlight REIT, Prosperity REIT, and New Century REIT.

In other words, the greater proportion of income of a REIT shall be derived from rentals of real estate;

(b) not engage in active trading of real estate (i.e. a property must be held by the REIT for at least two years after acquisition or development, unless unitholders' approval is obtained);

(c) distribute a significant portion of its income (i.e. not less than 90% of its audited annual net income after tax) to unitholders in the form of regular dividends; and

(d) subject to a maximum borrowing limit (i.e. 45% of gross asset value).

7. The SFC would review the REIT Code from time to time in the light of overseas regulatory changes and local market developments and would revise the requirements where appropriate following public consultation. For example, in 2005, the REIT Code was amended to allow SFC-authorised REITs to invest in overseas properties. In 2010, the Code on Takeovers and Mergers and Share Repurchases[4] was extended to SFC-authorised REITs to align the requirements applicable to takeovers and mergers of REITs with that of listed companies.[5] In 2014, the REIT Code was further revised to allow REITs the flexibility to engage in property development activities up to a limited extent (see paragraph 8 below for details) for portfolio expansion or asset enhancement purpose[6]. The REITs can also invest in certain liquid financial instruments, subject to a limit in terms of gross asset value. In the public consultation in 2014, a majority of the respondents agreed that

[4] Now known as "The Codes on Takeovers and Mergers and Share Buy-backs" ("Takeovers Code").

[5] Such requirements include, for example, where any person acquires 30% or more of the voting rights of a REIT, the person would be required to make a mandatory offer to the other unitholders pursuant to the provisions of the Takeovers Code to ensure all unitholders are treated even-handedly so as to protect minority unitholders' interests.

[6] It should be noted that prior to this, a REIT was already allowed to acquire uncompleted units in a building which was unoccupied and non-income producing or in the course of substantial development, redevelopment or refurbishment to a limited extent.

the amendments would keep Hong Kong's REIT regulatory regime competitive and facilitate the long-term growth of the Hong Kong REIT market[7]. Indeed, the changes would be in line with international trends[8].

8. Considering the nature of REITs as an investment product which seeks to provide recurrent rental income, despite the 2014 amendments, REITs must still invest primarily (at least 75% of its gross asset value) in real estate that generates recurrent rental income. In addition, property development activities of REITs are subject to a number of restrictions under the REIT Code. They include that property development costs are capped at 10% of the REIT's gross asset value ("10% Cap").

9. According to the REIT Code, a REIT is subject to reporting, disclosure, and in some cases, unitholders' approval requirements for certain actions taken (such as transactions relating to material acquisitions or disposals of properties). More specifically, with regard to property development activity, the management company of the REIT should consult the trustee and issue an announcement to inform unitholders of the details of such engagement. Periodic updates must also be provided in the interim and annual reports, including all material information concerning the property development activity and the extent to which the 10% Cap has been applied. Such disclosure has to be reviewed by the audit committee of the management company.

10. Furthermore, the annual reports of a REIT must be filed with the SFC and published. If there is any information in the reports which suggests there may be non-compliance with the requirements under the REIT Code, the SFC would make enquiries and take appropriate follow-up actions. Over the years, there have not been any major issues with the implementation of the REIT Code or the overall compliance with its requirements. Cases of minor irregularities (e.g. omission of provision of

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[7] In its report on "Developing Hong Kong as a Capital Formation Centre for Real Estate Investment Trusts" published in November 2013, the Financial Services Development Council echoed the respondents' views in the sense that the prohibition of REITs from participation in property development had made Hong Kong's REIT market less competitive than that of Singapore, among other overseas jurisdictions.

[8] Singapore also allows its REITs to engage in property development activities. In 2014, the limit was 10% of the total assets. It has been further relaxed to 25% since 2016, subject to certain conditions. In the United States, Australia and Malaysia, REITs are similarly allowed to perform property development activities up to a certain extent.

brief summary of certain connected party transactions in the interim report) are duly addressed by the REITs concerned after the SFC's follow-up. Also, the management company of a REIT, which is a Type 9 licensee, has to comply with conduct requirements applicable to SFC-licensees. These include carrying out its responsibility under the REIT Code to ensure that the REIT under its management is managed in accordance with the relevant regulations.

11. In summary, the REIT Code has laid down various requirements concerning the management structure and investment scope of REITs, which are pertinent to a REIT being an investment product which primarily holds real estate generating rental income, having regard to the protection of the interests of the investing public. Like other investment products, a REIT (even before the 2014 amendments to the REIT Code) can always adjust its investment portfolios (through, for example, the selling of certain assets and the purchase of something else) in accordance with its investment strategies, subject to compliance with its constitutive documents. These would essentially be commercial decisions. The SFC would not be in a position to interfere with these decisions provided that the REIT is in compliant with the requirements as laid down in the REIT Code.

ADVICE SOUGHT

12. Members are invited to note the implementation of the REIT Code as set out in the paragraphs above.

Financial Services and the Treasury Bureau
The Securities and Futures Commission
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