Hong Kong Update: The Progress of REITs in Hong Kong

Judging by the 50-plus submissions received by the SFC during the consultation period, there is keen interest in the much-publicized proposal to allow Real Estate Investment Trusts (“REITs”) to be offered to the Hong Kong public.

Whilst the first draft of the Code on REITs highlights the SFC’s concern to ensure that there are sufficient measures to protect investors, this rather paternalistic approach has unfortunately failed to yield an investment framework which is likely to have the necessary flexibility built into it to be realistically workable to the fund management and property industry.

On balance, based on the responses received, the framework under the draft Code is overly restrictive and will necessitate some key changes if REITs are to become a successful investment product in Hong Kong.

The key and most contentious requirements include:

• that the REIT must be structured in the form of a trust
• a requirement that the management company be licensed to manage collective schemes and have a five-year track record in managing public funds
• onerous obligations on the part of the trustee
• a requirement to distribute 100 percent of the REIT’s after-tax income as dividend
• restrictions on the type and location of real estate investments, in particular the requirement that a REIT only invest in Hong Kong real estate
• a requirement that the REIT directly hold the real estate
• a requirement that the REIT hold its real estate for a minimum period of years unless otherwise approved by its unit holders
• an arbitrary limit on the extent to which a REIT may borrow and leverage its assets

The geographical restriction to only permit investments in Hong Kong real estate has attracted the most comment. Many industry observers see this as an unnecessary restriction which will lessen the attractiveness of REITs to Hong Kong investors, particularly as it will exclude access to the potentially lucrative market in China.

Another disincentive, which does not accord with the practices in other sophisticated REITs jurisdictions such as the U.S. and Australia, is the maximum borrowing limit of 35 percent of the REIT’s net asset value.

From the management point of view, there is genuine concern that the five-year track record in public fund management will rule out many property companies. Many argue that the key requirement should be experience in property management and not traditional fund management. Some management companies may still be able to qualify if they satisfy the SFC that they belong to a management group with an established record of managing REITs operating in a similar fashion to REITs under the Code.

Another significant issue, in particular for property companies looking to restructure their property holdings through REITs, will be its tax treatment. Whilst the SFC took the view in releasing this first draft of the Code, that under Hong Kong’s existing tax regime there is no need to provide additional tax incentives in order to create a vibrant REIT market in Hong Kong, more flexibility to the structure, including the option of a corporate structure and the ability to hold real estate through a corporate intermediary, should be permitted to reduce the REITs overall taxability.

An overarching observation which is consistent with the SFC’s paternalistic approach is the endless vetting role that the SFC is empowered with under the draft Code. Perhaps a
lesson could be learned from the largely successful Australian experience which adopts a more disclosure-orientated approach towards achieving investor protection.

Whilst the initial draft of the Code is overly restrictive, it has at least served the purpose of producing a fertile consultation process amongst industry experts. One key factor that bodes well for possible changes to the initial draft is that responsibility for the process rests with the Investment Products Department of the SFC which has in the past been receptive to reasoned comment. It is hoped that the SFC will adopt this approach and elect to produce a revised draft of the Code later in the year.

Judging by the interest, there would seem to be an appetite amongst Hong Kong investors for this new asset class. One hopes that the regulatory regime will be accommodating of this.

Further Information

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