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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 5, 2005

VIA E-MAIL: reits@sfc.hk

Investment Products Department
The Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
Hong Kong

RE: Consultation Paper on Draft practice Note on Overseas Investments by SFC-Authorized Real Estate Investment Trusts (March 2005) (the Consultation Paper)

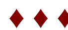
Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® (NAREIT) thanks you for this opportunity to submit comments on the proposal discussing the above-referenced Consultation Paper (the Proposal). NAREIT is the representative voice for United States real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Members are U.S. REITs and other public businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

Investment Outside Hong Kong

NAREIT strongly supports the Proposal by the Securities and Futures Commission's (SFC) to permit Hong Kong REITs to invest in overseas properties. The overwhelming majority of REITs worldwide are permitted to invest in properties outside of their country of organization, thereby enhancing their abilities to provide the full benefits of real estate investment to their shareholders. The United States' Internal Revenue Service clarified this issue over 30 years ago in Revenue Ruling 74-191.

Over the past decade, the commercial real estate business has matured from a local business to one with a global dimension. For example, many of the U.S. REITs concentrating on owning and leasing industrial facilities listened to their customers who wanted the same type of logistical and other services provided at U.S. locations to be offered outside the United States. To comply with their customers' needs, these companies now operate throughout Asia, Europe and



North America. In addition, several shopping mall U.S. REITs determined that their tenants based both in the U.S. and overseas could best be served also offering to them opportunities to also lease space in Asia and Europe. Restricting a REIT's investment opportunities to a particular geographical area places artificial restrictions on a company's business goals. Such restrictions also limit the ability of a company to more fully diversify its investments since the economic performance of different geographical areas permits a REIT's managers to soften any slow economic activity in one area with the robust activity in another location.

We also believe that lifting geographical limits on a Hong Kong REIT's ability to invest could better promote cross border investments in Hong Kong REITs because investors would be able to compare the Hong Kong REIT's investment decisions with those made by REITs around the world.

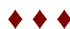
Supervision of REIT Management

Before addressing some of the specific issues raised by the Proposal, we would like to raise the possibility that the Commission consider changes that would allow (but not mandate) internal management. NAREIT believes that a REIT that is internally managed may address any potential conflict of interest issues arising from internal management structures, and therefore we do not believe that there need be any distinct regulatory supervision or rules for listed, internally managed REITs. Instead, we believe such REITs should be subject to the same rules as listed companies that focus on businesses other than real estate.

As originally created by the U.S. Congress in 1960, a U.S. REIT was only allowed to hold properties and its employees were not empowered to provide even basic real estate services to their tenants. The original statute required a REIT to engage the services of an "independent contractor" to provide such basic real estate services as maintenance of the properties the REIT owned. The practice developed in the United States that the independent contractor a REIT retained to provide these services was owned and controlled by the REIT's officers. This arrangement led to situations under which the REIT paid substantial sums to entities benefiting the REIT's officers, not the REIT shareholders.

It was not until the Tax Reform Act of 1986 that Congress decided that REITs should be able to provide "customary services" to its tenants, thereby resolving potential conflicts of interest and allowing REIT management to maximize the revenue potential of REIT properties for the benefit of their investors. The 1986 change has been widely acknowledged as having been a necessary ingredient for the dramatic growth of publicly traded U.S. REITs beginning in the early 1990s. As with other publicly traded companies, employees of internally managed REITs do not work for other entities and therefore are fully focused on creating value for the shareholders.

Therefore, we encourage the Commission to explore the possibility of allowing Hong Kong REITs to be internally managed. We note that the trend in Australian Listed Property Trusts to be "stapled" with corporations in effect has allowed the investors in those companies to reap the benefits of internal management.



Gearing

The Proposal suggests increasing the statutory 35% limit on gearing to 40-50%. NAREIT suggests that the Commission adopt the most flexible gearing ratio possible and then let the market determine whether the REIT managers have adopted the best business model.

In the United States, REIT leverage rose to the 70%-80% range in the late 1980s and early 1990s. After the real estate downturn caused in part by the savings and loan crisis, the market in the mid-1990s provided equity in initial public offerings only to those companies that used very conservative leverage ratios in the low 30% range. Since then, U.S. REITs have produced consistent operating results and both the equity markets and the credit rating agencies have become comfortable with leverage ratios in the 45-50% range. However, restricting the leverage ratios to a fixed percentage could severely limit a manager's ability to cope with changed economic conditions.

Management Compensation

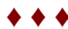
The Proposal asks comments on "special product features" such as payment of management fees by way of issuing REIT securities. In general, NAREIT recommends that REIT managers be compensated in a way that best aligns their interests with the interest of the REIT investors. REIT managers should be encouraged to have a vested interest in the REIT's performance, and appropriate issuance of REIT securities to REIT managers could be a reasonable method of reaching that goal. In the United States, analysts have estimated that management ownership of REIT securities is between 10% and 15%, which was largely achieved by the managers contributing assets to a REIT or its affiliate.

In the United States, stock compensation arrangements with the top REIT executives are normally determined by a committee of independent board directors and are often ratified by the shareholders. The Commission may wish to consider similar independence checks on compensation arrangements with REIT managers.

In addition, in the United States in the last decade sponsors of private real estate funds have begun investing 10-20% in the funds to demonstrate to institutional investors that their interests are aligned with the desire to produce attractive income flows and capital gains rather than merely obtaining fee income. The Commission may wish to consider some minimum investment in Hong Kong REITs by the managers to achieve the same results.

Property Ownership Requirement

Paragraph 25 of the Draft Practice Note states that a "management company shall ensure that the REIT has ownership of more than 50% in the property at all times." There are number of circumstances when this limitation could deprive a Hong Kong REIT from making a productive investment. First, it is unclear whether this limit could prevent a Hong Kong REIT from investing in real estate through an intervening entity. In the United States, most joint ventures are



structured as limited partnerships or limited liability companies, and it is not clear whether an investment through one of these entities would be considered an investment in “property.”

Second, there may be tax reasons why the 50% limit may prevent the REIT from obtaining the nest economic return from its overseas investment. For example, sales of U.S. real estate by non-U.S. investors usually are subject to full U.S. income tax under the Foreign Investment in Real Property Tax Act (FIRPTA) section of the U.S. tax code. However, an exception applies to sales of stock in a “domestically controlled” REIT, which is defined as a U.S. REIT that is 50% or more owned by U.S. persons. Many non-U.S. investors invest in U.S. real estate through this structure so that any appreciation in their investment is not subject to U.S. tax. Under the limit contained in paragraph 25 of the Draft Practice Note, Hong Kong REITs would be precluded from investing through this tax-efficient structure, thereby decreasing net returns to its shareholders if it chooses to invest in the United States.

Third, an increasing number of U.S. REITs have found it useful to contribute some of their assets to joint ventures with institutional (including non-U.S.) investors while retaining a significant, though less than majority, share of the venture. The U.S. REITs often redeploy the funds they receive from contributions to these ventures into other real estate projects, thereby decreasing their need to return to the markets to meet their capital needs. The 50% limit would prevent Hong Kong REITs from using these “capital recycling” strategies.

* * *

NAREIT appreciates the opportunity to provide these comments with regard to the Proposal. Please contact the undersigned at (202) 739-9408 if you would like further information or would like to discuss our comments in further detail.

Respectfully submitted,

Tony M. Edwards
Senior Vice President and General Counsel