NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

REITS: BUILDING DIVIDENDS AND DIVERSIFICATION®

November 5, 2014

**VIA E-MAIL: reits@mas.gov.sg**

Market Conduct Department
Monetary Authority of Singapore
10 Shenton Way
MAS Building
Singapore 079117

Re: Consultation Paper on Enhancements to Singapore's Regulatory Regime Governing REITs and REIT Managers

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts (NAREIT)® greatly appreciates the opportunity to provide its comments regarding the October 2014 "Consultation Paper on Enhancements to the Regulatory Regime Governing REITs and REIT Managers" (the Paper) issued by the Monetary Authority of Singapore (MAS). NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

NAREIT applauds Singapore for its willingness to consider improvements to the Singapore REIT regime. NAREIT believes that the success of REITs in the United States is largely attributable to the appropriate flexibility of its governing rules, which generally rely on market discipline rather than government-issued regulations to determine various important matters such as debt levels, self-management versus external management, and whether to develop or purchase properties. Accordingly, and as further set forth below, we generally believe that it would be preferable for the MAS not to impose certain specific regulatory requirements relating to development and leverage limits as suggested in the Paper, and, instead, to let market forces guide the development of Singapore's REIT industry, especially with regard to self-managed companies.

## EXECUTIVE SUMMARY

NAREIT is pleased that the MAS is considering a number of proposals relating to strengthening corporate governance, aligning incentives between Singapore REIT managers and unitholders, operational flexibility, and operational requirements on Singapore REIT managers, and structuring of Singapore REITs (including proposals regarding so-called "stapled" entities).

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As further set forth below, NAREIT generally supports the motivations underlying MAS' proposals to strengthen corporate governance standards and align incentives between Singapore REIT managers and unitholders. Additionally, NAREIT urges Singapore to take the opportunity to expand the authorization of internal management beyond "stapled" entities and allow Singapore REITs to be either externally or self-advised. Moreover, NAREIT recommends allowing Singapore REITs greater flexibility to develop properties for their own account. Finally, NAREIT recommends that Singapore allow the market to determine the appropriate leverage for Singapore REITs, rather than imposing a regulatory constraint on borrowing, but that if leverage limits are imposed they should be based on a metric like interest coverage rather than debt/equity ratios.[1]

## DISCUSSION

### I. Background: U.S. REITs Have Benefited Investors and the Economy

By way of background, the U.S. Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through companies modeled after mutual funds. REITs combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, communication towers, data centers, health care assets such as senior housing, hotels, offices, shopping centers, storage facilities, timberlands, and warehouses. Not only are U.S. REITs required to distribute at least 90% of their taxable income to their shareholders, they also must satisfy a host of other operational requirements, including ensuring that most of their income and assets are derived from real estate sources. In exchange for doing so, U.S. law grants REITs a dividends paid deduction (DPD), just as it does for mutual funds. To the extent that a U.S. REIT retains taxable income, it is subject to an entity-level tax on such retained income. In 2013, publicly traded U.S. REITs distributed more than $34 billion to their shareholders.

Congress' vision has been realized: as of September 30, 2014, nearly 200 publicly traded REITs had a total equity market capitalization of almost $800 billion. Throughout the U.S., real estate owned by REITs generates millions of dollars in property taxes on top of the individual income taxes currently generated by REIT dividends paid to state residents. Investors have benefited from owning REITs: the 15-year compound annual return for the period ending September 30, 2014 of the S&P 500 stock index was 4.87%, while that of all equity (property-owning) REITs was 11.70%. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public equity REITs are around 35%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Additionally, academics have noted the positive impact REITs have due to the transparency of information about commercial real estate that becomes available to investors, financial institutions, regulators, and private real estate investors.[2] Simply

[1] NAREIT submitted similar comments in 2005 to the MAS: http://www.reit.com/sites/default/files/media/Portals/0/Files/Nareit/htdocs/policy/government/Changes%20to%20Singapore%20REIT%20Rules%2071105.pdf.
[2] Frank Packer, Timothy Riddiough, and Jimmy Shek, *Securitization and the Supply Cycle: Evidence from the REIT Market*, 39 J. PORTFOLIO MANAGEMENT 134, 135 (2013).

put, REITs are the most practical method for investors to add commercial real estate in their investment portfolios to obtain the asset diversification recommended by most financial advisors.

## II. NAREIT Supports the Enhancement of Corporate Government Standards

In the U.S., the provisions of *The Sarbanes-Oxley Act of 2002*,[3] The *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank)[4] and those of exchanges such as the New York Stock Exchange (NYSE)[5] apply to listed companies, including REITs, and require them to have robust corporate governance standards and their management and directors to have fiduciary responsibilities with respect to investors, including having a majority of independent directors and strong audit committees.[6] Furthermore, federal securities laws, applicable to companies with more than $10 million in assets whose securities are held by more than 500 owners, require a significant level of transparency and disclosure regarding compensation of key employees and material contractual obligations. Additionally, state statutory provisions and case law affirm that a corporation's directors and management (including those of a REIT) have a fiduciary duty to shareholders, including a duty to avoid conflicts of interest.[7]

Accordingly, NAREIT generally supports intentions motivating the MAS proposals set forth in the Paper to strengthen corporate governance and enhance disclosure, including those in Section 1 ("Strengthening Corporate Governance")**.** Moreover, some in the marketplace believe that there are fewer conflicts of interest when REITs are internally managed. Therefore, as further described below, in addition to the above changes, we believe that the most important step Singapore could take to enhance corporate governance would be to allow for internally advised and managed REITs.

## III. Allow for Singapore REITs To Be Either Externally-Advised or Self-Advised

The Paper requests comments regarding potential modifications to the "stapled" REIT structure, whereby "units in a REIT are stapled to units in a business trust (BT). While the REIT and the BT continue to exist as separate entities under the stapled securities structure, the stapled group trade as one 'counter' and share the same investor base."[8] NAREIT believes that the stapled REIT structure is a work around to the general rule that does not accept internally advised/managed REITs. Instead of merely modifying the rules applicable to stapled REITs, we urge the MAS to take this opportunity to build on its status as a leader in the Asian financial markets to follow the model of the U.S., Canada, South Africa, U.K. and several other European countries and modify the law in order to permit Singapore REITs the option to be either externally or internally advised (also called "self-advised").

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[3] Available here: http://www.gpo.gov/fdsys/pkg/BILLS-107hr3763enr/pdf/BILLS-107hr3763enr.pdf
[4] Available here: http://www.gpo.gov/fdsys/pkg/CRPT-111hrpt517/pdf/CRPT-111hrpt517.pdf.
[5] *See, e.g.*, Section 3 of the NYSE's Listed Company Manual, available here: http://nysemanual.nyse.com/LCMTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F3&manual=%2Flcm%2Fsections%2Flcm%2Dsections%2F.
[6] The U.S. Securities and Exchange Commission (SEC) has adopted literally dozens of rules under Dodd-Frank for SEC-registered companies. *See*, *e.g.*, http://www.sec.gov/spotlight/dodd-frank/accomplishments.shtml#cgov.
[7] *See*, *e.g.*, *Shenker v. Laureate Educ. Inc.*, 411 Md. 317, 351 (2009).
[8] Paper at 21.

U.S. REITs started out in 1960 as being only externally advised, but in 1986 the U.S. Congress wisely decided to also allow REITs to be internally managed. Most observers believe that the "modern REIT era" that started in the early 1990s with a wave of initial public offerings would not have been possible unless the REITs were internally managed because institutional investors wanted to avoid even the appearance of conflicts of interests that are possible with an externally advised model.[9]

NAREIT does not take a position as to whether either management alternative is the preferred structure. Instead, NAREIT suggests that both types of companies be allowed so that investors can make their own decision. As noted below, the listed U.S. REIT industry has moved to more of a self-advised model over the past 30 years.

A self-advised REIT has its own employees who devote all of their time to the REIT just like the employees of any other U.S. publicly traded company. An externally-advised REIT typically hires a separate business entity, which can be an investment manager, bank or insurance company or an affiliate of these entities, to supervise the ongoing entity-level operations of the REIT in exchange for an advisory fee. Such advisory services include, for example, making decisions or recommendations to buy or sell a property, declare dividends, raise capital, or hire on-site mangers or other employees, in all cases subject to the oversight of the company's board of directors or trustees. An externally-advised REIT can have employees as well, but it subcontracts with an outside entity for supervisory services.[10]

Some observers believe that there is a greater potential for conflicts of interest for an externally-advised REIT than for a self-advised REIT, especially when the REIT employees own the external advisor.[11]

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[9] Feng, Zhilan, Price, S. McKay, Sirmans, C. F., Review Articles: An Overview of Equity Real Estate Investment Trusts (Reits): 1993-2009, J. REAL ESTATE LITERATURE, Vol. 9, No. 2 , May 1, 2011.

[10] As a side issue to whether the Singapore REIT is externally-advised or self-advised, an **externally-managed** REIT is not only typically **externally advised,** but also typically uses outside entities (called "independent contractors") to provide on-site services to tenants at its properties. In contrast, a **self-managed** REIT provides these services through its own employees. (This definition applies to "equity REITs," which are REITs that own real estate rather than "mortgage REITs," REITs that own mortgages.). In the U.S., Congress has permitted REITs to be self-managed since 1986, and today nearly all listed U.S. REITs are self-managed. NAREIT's recommendation is that the MAS permit Singapore REITs the option to be either **externally-advised** or **self-advised**.

[11] *See, e.g.*, Susanne Cannon and Stephen Vogt, *REITs and Their Management: An Analysis of Organizational Structure, Performance and Management Compensation*, 10 JOURNAL OF REAL ESTATE RESEARCH 297 (1995). *See also Corporate Governance of Externally Managed REITs Presents Credit Risks* (Moody's, November 2007) available at https://www.moodys.com/sites/products/AboutMoodysRatingsAttachments/2007000000456227.pdf *(*discussing corporate governance and credit risks and factors to mitigate those risks for externally managed REITs). *Cf. Real Estate Investment Trusts: The US Experience and Lessons for the UK* (Investment Property Forum, May; 2009) at page 21, available at: http://www.cornerstoneadvisers.com/_pdf/REITsTheUSExperienceandLessonsfortheUK.pdf (noting that "[t]oday a US REIT can choose whether to be internally or externally managed, and almost all have chosen the internal option.").

In the last few decades, some externally-managed REITs have addressed these potential conflicts of interest by various mechanisms, *e.g.*, requiring the REIT employees or sponsor to invest their own capital in the REIT and by linking the compensation of the outside advisor to performance-based criteria, rather than to assets owned by the REIT.

Although there is no legal requirement that a U.S. REIT be self-advised, the capital markets tend to prefer that listed U.S. REITs be self-advised. Accordingly, as of December 31, 2013, about 97% of listed equity (property-owning, as opposed to mortgage-owning) U.S. REITs by equity market capitalization were self-advised. Most non-traded U.S. REITs appear to be externally advised.

Self-advised REITs do not need outside advisers, thereby obviating potential conflict of interest issues arising from external management structures. Therefore, we do not believe that there need be any distinct regulatory supervision or rules for listed, self-advised REITs that are above and beyond those applicable to listed public companies generally. Furthermore, we believe that the market perception of inherent conflicts of interest between REITs and their related parties, independent of any specific disclosure requirements, could lead more Singapore REITs to become self-advised over time.

## IV. NAREIT Recommends Allowing Unlimited Development for REIT’s Own Account

### A. *Background*

Under current Singapore law, the total contract value of property develpment activities undertaken and investmetns in uncompleted property by a REIT should not exceed 10% of the REIT's deposited property. This requirement is intended to limit a Singapore REIT's exposure to the risks and uncertainties associated with property development.

The MAS proposes to allow a REIT to undertake development activities up to 25% of its deposited property, but only if: a) the REIT obtains specific unitholders' approval for the higher developent limit of 25%; and, b) the additional 15% allowance (over and above the current 10% limit) is utilized solely for the redevelopment of an existing property that has been held by the REIT for at least 3 years, and which the REIT will continue to hold for at least 3 years after redevelopment.

### B. *Allow Greater Development for REIT’s Own Account*

The Paper would limit the extent to which an Singapore REIT could develop properties for its own account to no more than 25% of the REIT’s assets, and then only if the completed property is held for and leased for at least three years after completion. NAREIT believes that flexibility in respect of property development investments and related activities should be introduced for Singapore REITs. Specifically, NAREIT recommends that Singapore REITs be permitted to develop investment property for their own accounts without any limitation so long as the property is not held primarily for sale in the ordinary course of the REIT's business, and that a safe harbor be provided for rental property held for at least two years.

U.S. REITs may develop property for their own account that, once developed, they hold for investment. In the U.S. context, the relevant inquiry is whether the property is held as investment (for the long term) or as inventory as a dealer (for the short term). This rule provides the flexibility for those REITs that have property development expertise to benefit their shareholders by undertaking development for their own account, thereby achieving cost efficiency and savings. This rule also helps spur development by REITs with particular development and redevelopment expertise.

Gains attributable to the sale of "dealer property" are taxed to a U.S. REIT at a 100% tax rate. On the other hand, gains from the sale of property held for investment are qualifying real estate income. Thus, the REIT faces strong discouragement, but not loss of REIT status, from directly developing property for third parties. The determination of whether property is "dealer property" is based on the facts and circumstances of the situation, but a safe harbor does apply. A U.S. REIT may develop properties for third parties through its fully taxable subsidiary (which may not be greater than 25% of the U.S. REIT's gross assets).

Specifically, no tax is imposed on a U.S. REIT's property sales if, among other requirements, the REIT has 1) held the property for at least 2 years; 2) not spent more than 30% of the net selling price of the property over the last 2 years; and, 3) not made more than 7 sales of property within the taxable year (or the aggregate fair market value or adjusted bases of property sold during the taxable year does not exceed 10% of the fair market value or aggregate adjusted tax bases of all of the REIT's assets as of the beginning of the taxable year). Further, these objective tests are merely a "safe harbor," and so a REIT will not be assessed the 100% tax if it can demonstrate that it did not act as a dealer based on the surrounding facts and circumstances.

## V. Allow Market Discipline to Determine Appropriate Debt Levels

The Paper seeks comments on the MAS' proposal "to adopt a single-tier leverage limit of 45% (without requirement for credit rating) and remove the option for a REIT to leverage up to 60% by obtaining a credit rating." Again, the U.S. experience may be instructive in this context. U.S. law does not provide a limit on the amount of debt that a REIT may incur. NAREIT believes that market forces are the best determinants of the appropriate level of gearing.

The public market (*e.g.*, analysts, investors and credit agencies) in the U.S. has encouraged listed REITs to incur a lower level of debt compared with commercial real estate held privately. These market forces, rather than specific legislative requirements, have created this situation. As a result, as of September 30, 2014, the average debt to market capitalization for listed U.S. equity REITs (property-owning REITs, as opposed to REITs that own mortgages or a combination of mortgages and property) was 33.2 %, their coverage ratio of EBITDA divided by interest expense was 3.8 and their fixed charge rate of EBITDA divided by interest expense plus preferred dividends was 3.5.

Additionally, the market may consider different debt amounts appropriate for different property sectors. Rating agencies also provide an outside force to limit gearing. For example, as of September 30, 2014, 46 U.S. equity REITs, or 68% of the industry by equity market capitalization, had investment grade ratings. For these companies to increase borrowing, they must be prepared to address credit agency concerns and expectations. Furthermore, as the capital markets have become more comfortable with publicly traded REITs and their use of debt, the level of leverage borne by REITs has fluctuated, sometimes increasing as market conditions warranted.

The lower debt levels associated with REITs compared to privately-owned real estate investment in the U.S. overall have had a positive effect throughout the economy. Average debt levels for U.S. REITs are 30-40% of market capitalization, compared to leverage of 60% and often higher that is used when real estate is privately owned. The higher equity capital cushions REITs from the negative effects of fluctuations in the real estate market that have traditionally occurred. The ability of REITs better to withstand market downturns have had a stabilizing effect on the real estate industry and its lenders, resulting in fewer future bankruptcies and work-outs. Consequently, the general U.S. economy has benefited from reduced real estate losses by federally insured financial institutions, and thus benefited from reduced system risk in the U.S. financial sector.

NAREIT recommends that the MAS provide the flexibility to meet different market challenges and not limit the level of gearing for a Singapore REIT. If the MAS believes that there must be some limitation on gearing, then NAREIT suggests that gearing be limited based on reference to a REIT's interest coverage ratio (earnings before interest and taxes for a one year, divided by interest expenses for the same year). This is the type of limitation provided for in the U.K. REIT regime. Specifically, the U.K. provides that the interest coverage ratio not be permitted to fall below 1.25, but, to the extent the ratio does fall below 1.25, a tax liability will attach to the amount that causes the ratio to fall below the 1.25 limit. Further, NAREIT recommends that a Singapore REIT should have the ability to petition the Singapore government for an exception to any leverage limits to account for unforeseen market conditions.

Thank you for the opportunity to submit these comments. Please contact me at tedwards@nareit.com or Dara Bernstein, NAREIT's Senior Tax Counsel, at dbernstein@nareit.com if you would like to discuss the comments in greater detail.

Respectfully submitted,

Tony M. Edwards

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