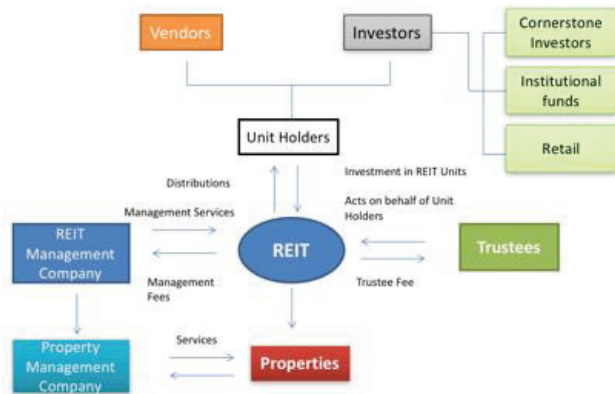


Some Recent Developments with REITs in Malaysia

by Eileen Tan Yuh Wen

In Malaysia, real estate investment trusts (or “REITs”) are generally governed under trust law. Elsewhere, in the US, for example, REITs can be organised as a corporation, a trust, a limited liability company or, in certain cases, a limited partnership.¹ A REIT in Malaysia is constituted by the trust deed executed between its management company (commonly referred to as the “manager” of the REIT) and the trustee that holds legal title to the REIT’s assets and acts on behalf of the unit holders.

An illustration of a typical conventional REIT in Malaysia is as follows:



Legislative framework

In Malaysia, the business and operation of a REIT is principally regulated by Securities Commission Malaysia (“SC”) pursuant to the Capital Markets and Services Act 2007. In carrying out this responsibility, the SC has issued guidelines for property trust funds that have been developed and revised several times along with the growth of the REIT market in Malaysia before being replaced by the SC’s Guidelines on Real Estate Investment Trusts in 2008 (updated 28 December 2012) (“REIT Guidelines”). Therefore, REITs in Malaysia are effectively governed by the REIT Guidelines, including the SC’s Guidelines on Islamic Real Estate Investment Trusts (for Islamic REITs) and the respective REIT’s trust deed.

In July 2016, the SC published a consultation paper inviting public feedback on its proposed changes to the REIT Guidelines and the Islamic REIT Guidelines.

Objectives

The main objectives of the SC’s proposed amendments to the REIT Guidelines are to facilitate growth of the REITs market by liberalising the scope of permitted activities that can be undertaken by REITs, enhance governance requirements, and to streamline post-listing requirements for listed REITs with those for listed corporations which should achieve greater market efficiency for REITs.²

Facilitate growth

The SC has proposed that REITs be allowed to redevelop their existing properties or acquire vacant land for the purpose of developing new properties, thereby expanding the scope of permitted activities that can be undertaken by REITs, which will, among others, enable REITs to expand their portfolio of income-generating real estate.

¹ *Guide to Global Real Estate Investment Trusts* (Wolters Kluwer, 2010) (Stefano Simontacchi and Uwe Stoschek, eds) at para 2.1.1

² SC press release (14 July 2016)

Property development activities

At present, a REIT is not permitted to conduct property development activities and undertake acquisition of vacant land.³ However, it is allowed to acquire properties under construction valued at up to 10% of their total asset value (post-acquisition).⁴ The SC recognises that by allowing REITs to undertake redevelopment of their old properties and acquire vacant land for purposes of developing new properties, this will enable them to expand their portfolio of income-generating real estate and enhance the property yield for the benefit of unit holders.⁵

This has been allowed for REITs in other jurisdictions. For instance, last year, the Monetary Authority of Singapore raised the ceiling for development activities undertaken by a REIT from 10% (currently the ceiling for Hong Kong⁶) to 25%⁷ of the REIT's total asset value.

Since the primary aim of a REIT is to provide returns derived from rental income to unit holders, in order to ensure that the property development activities are undertaken for the purposes of improving rental income potential and to prevent exposure to risks associated with property development activities (such as possibility of cost overruns, financing and potential risk of delay in completion which will increase costs), the SC has further proposed the following restrictions:

- (1) The aggregate limit for property development AND acquisition of vacant land for purposes of development shall not exceed 15% of the

REIT's enlarged total asset value. In this regard, the current allowance for REITs to acquire real estate under construction up to a limit of 10% of their total asset value (post-acquisition) will be subsumed within this limit of 15%;

- (2) The REIT must continue to hold the completed property for at least two years from the date of completion of the property development; and
- (3) In the event that the REIT wishes to dispose of the completed property during the two-year holding period, it must seek its trustee's consent and obtain approval from unit holders by way of a special resolution.

For the avoidance of doubt, it is proposed that "property development activities" be defined as "the construction or re-development of a building or the extension to an existing building", and would not include renovation, refurbishment or retrofitting⁸ which is permitted under the existing REIT Guidelines.⁹

To ensure that REITs have a substantial portion of their investments in income-generating real estate, the SC has, together with the proposed liberalisation of permitted activities, proposed that the threshold for minimum investments in real estate and/or single purpose companies be increased from the current requirement of 50% of a REIT's total asset value to 75%.¹⁰

3 REIT Guidelines at para 8.44

4 *Ibid*, at para 8.14(e)

5 SC Consultation Paper No 3/2016 (14 July 2016) at para 2.2

6 SFC Code on Real Estate Investment Trusts at para 7.1(2)

7 MAS Code on Collective Investment Schemes, Appendix 6 at para 7.1(d)

8 *Supra* n 5 at para 2.5

9 *Supra* n 3

10 *Ibid*, at para 8.07

Private leases

The SC has proposed that REITs be allowed to enter into long-term leases with registered proprietors of income-generating real estate, subject to the following requirements being met:

- (1) The private lease must be registered with the Land Office (where the private lease relates to foreign real estate, to be registered or recognised by the relevant land authority under a land registry framework equivalent to that of Malaysia);
- (2) The total value of private leases with remaining lease period of less than 30 years should be below 25% of the total asset value (after acquisition) of a REIT;
- (3) The REIT manager must obtain legal advice on the acquisition of the private lease to ensure the interests of the REIT are protected in the lease agreement; and
- (4) The REIT manager must provide additional disclosure on such private lease arrangements in the prospectus, announcements, circulars and annual reports (where applicable) which shall include, among others, the remaining term of the lease held by the REIT, registration of the lease with the Land Office (or its equivalent for foreign real estate), name of the lessor, whether the lessor is a related party and such

other information relevant for the investors' consideration in deciding whether to invest or stay invested in the REIT.

These changes suggest that equitable ownership are thought to gradually be equated to legal ownership which should outweigh any major shortcomings where substantial profit can be reaped.

Income support

There are currently no specific provisions in the REIT Guidelines for income support arrangements. An income support arrangement is one where a vendor of real estate provides minimum rental income for a fixed period. This can take various forms, for example, by way of a minimum rental guarantee by the vendor, sale and leaseback arrangement to the vendor at above market rate, or such other forms of financial engineering with the effect of artificially enhancing the yield of a property on an unsustainable basis.

The SC is rightfully concerned that the investors may be misled by the headline yield. Income support arrangements may provide only short-term enhancement to a REIT's yield which may not be sustainable after the arrangement lapses. This may have the effect of inflating the valuation of a purchased property. This has proven the case in other jurisdictions where income support arrangements for REITs are allowed. Accordingly, the SC has proposed that the impact of the income support arrangement be excluded from the market value of the real estate to be acquired for investors' consideration.

Unit buyback

There are currently no specific provisions in the REIT Guidelines for unit buyback. Further to industry requests to allow unit buyback for listed REITs, the SC has proposed to allow listed REITs to buy back their own units subject to restrictions and notification requirements similar to those applicable to unit buy-backs by a business trust under the Bursa Listing Requirements.¹¹

The SC and some key industry players believe that this would help REITs whose units are undervalued to buy back their units thus reducing their supply.

Islamic REITs

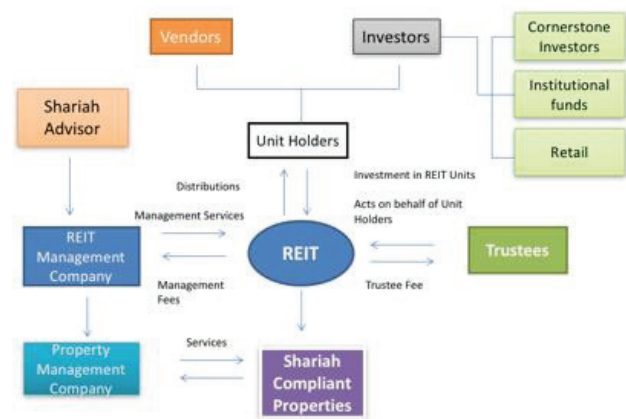
Islamic REITs are allowed to have up to 20% of total turnover attributable to existing non-Shariah compliant tenants.¹² However, they are banned from accepting new tenants or renewing existing ones whose activities are fully non-Shariah compliant even if the collection of rental income therefrom would not result in a breach of the 20% benchmark.

That prohibition is now replaced with the requirement that the percentage of rental derived from the non-Shariah compliant tenants is less than 20% of the Islamic REIT's total turnover and is reduced to less than 5% by the end of its fifth full financial year. For Islamic REITs established over five years, the proposed rule is that collection of rental income from non-Shariah compliant activities must be less than 5% of that Islamic REIT's total turnover.

Similar rules would apply to acquisition of real estate whose tenants carry out non-Shariah compliant activities.

Effectively, changes in the rule would provide an opportunity for Islamic REITs to achieve a higher occupancy rates.

A typical Islamic REIT structure in Malaysia is as follows:



Enhance governance, streamlining and other amendments

The SC has also proposed several changes to the REIT Guidelines which aim to put listed REITs at the same level of governance as a corporation listed on the stock exchange. This is done by applying the rules under the Main Market Listing Requirements of Bursa Malaysia Securities Berhad ("Bursa Listing Requirements"), which aim to strengthen regulations for REITs. Although listed REITs are generally subject to the Bursa Listing

11 Bursa Listing Requirements, Chapter 12, Part I

12 Islamic REIT Guidelines at para 1.1(c)

Requirements, not all rules under the Bursa Listing Requirements are currently applicable to REITs.¹³

The changes that the SC has proposed to adopt for REITs are:

(1) Statement of corporate governance

It is proposed that the board of directors of REIT managers include a statement of corporate governance and internal control in the annual report of REITs.

(2) Requirement for an audit committee

The SC proposes that REIT managers establish an audit committee with the roles of providing oversight of the financial reporting process, audit process, the system of internal controls, risk management, conflict of interest in particular, those arising from related party transactions and regulatory compliance of the REIT.¹⁴

(3) Issuance of securities

Under the current rules in the Bursa Listing Requirements, listed corporations may issue new securities under a general mandate from shareholders, provided such issuance does not exceed 10% of the nominal value of their issued and paid-up capital.¹⁵ The proposed rule is to adopt requirements similar to those for listed corporations under the Bursa Listing Requirements for issuance of new shares or convertible securities for listed REITs, but with a ceiling of 20% instead which is currently applicable to REITs.¹⁶

(4) Issuance of bonus units

As for issuance of bonus units, the SC has proposed that listed REITs adopt the same benchmark for listed corporations so that listed REITs are only allowed to capitalise up to 80% of reserves arising from (real estate) revaluation surplus for any bonus issue of securities by way of such surplus.¹⁷

(5) Transactions

It is proposed that similar requirements for transactions undertaken by listed corporations under the Bursa Listing Requirements which currently do not apply to listed REITs¹⁸ be adopted. Therefore, it is envisaged that the requirements for transactions undertaken by listed REITs will be as follows:

*Acquisitions and disposal*¹⁹

Percentage ratio (of fund's total asset value)	Below 5% or for transactions where value is below RM500,000	5% or more	25% or more
Requirements	No announcement required (if consideration is satisfied in case of unquoted securities)	Announcement to be made	Announcement to be made
		Separate letter to be furnished to Bursa, the percentage ratios applicable to such transaction	Separate letter to be furnished to Bursa, the percentage ratios applicable to such transaction
			Draft circular to unitholders together with compliance checklist to be furnished to Bursa
			Circular to unitholders to be issued
			Approval of unitholders to be obtained

13 Bursa Listing Requirements at para 8.36

14 *Ibid*, at para 3.05

15 *Ibid*, at para 10.03

16 *Ibid*, at para 14.03

17 Paragraph 14.20 of the REIT Guidelines currently allows up to 90%: "Where a revaluation surplus is to be utilised for the issuance of bonus units, only up to 90% of such surplus may be capitalised as bonus units."

18 *Supra* n 13

19 Bursa Listing Requirements at para 10.05

In a related party transaction²⁰

Percentage ratio (of fund's total asset value) or transaction value	(Transaction value is less than RM500,000 or is a recurrent RPT)	0.25% or more	5% or more	25% or more
Requirements	None	Announcement to be made	Announcement to be made	Announcement to be made
			Draft circular to unit holders together with compliance checklist to be furnished to Bursa	Draft circular to unit holders together with compliance checklist to be furnished to Bursa
			Circular to unit holders to be issued	Circular to unit holders to be issued
			Approval of unit holders to be obtained	Approval of unit holders to be obtained
			Independent adviser to be appointed	Independent adviser to be appointed
			Principal adviser to be appointed	

In addition, the SC is considering removing the limitations to the acquisition and disposal pricing as set out under the current REIT Guidelines²¹ to provide the unit holders with flexibility to decide on transactions undertaken by the REIT. However, relevant and adequate information such as independent valuation reports — and, in the case of a related party transaction, independent advice — must be provided to unit holders.

In addition to the above, to enhance protection for investors, the SC has further proposed:

(1) Change of REIT manager

The SC proposes to allow unit holders including unit holders with interest in the outcome of the meeting to vote and be counted in the quorum to remove the REIT manager by way of a simple resolution. This relaxes the current rule in the REIT Guidelines that a REIT manager must not exercise its voting rights for its units or its nominees' units held in any unit holders' meeting regardless of the party who requested for the meeting and the matter or matters that are laid before the meeting.²²

(2) Termination of a REIT

In addition to the current rules under the REIT Guidelines, the SC proposes that on completion of the termination of the REIT, a REIT manager's report setting out the salient terms of the disposal of the REIT's assets and a trustee's report stating that the REIT has been terminated in accordance with the provisions of the REIT's deed must be made available to the unit holders. Further, it is proposed that copies of the financial statements of the REIT be distributed and filed with the SC within two months of the completion of termination.

20 Bursa Listing Requirements, at para 10.08

21 REIT Guidelines, paras 8.18, 8.19 and 9.04. Under the current REIT Guidelines, a fund should not: (i) acquire real estates at a price more than 110% of the value assessed in a valuation report; and (ii) dispose of real estates at a price lower than 90% of the value assessed in a valuation report.

22 REIT Guidelines at para 15.48

(3) Revaluation of real estate

Given the current practice of M-REITs, the SC proposes to replace the current requirement that revaluation of each real estate in a REIT to be carried out at least once every three financial years to at least once annually.²³ In addition, it is proposed that a valuer is allowed to conduct valuations of any particular real estate of a REIT for a maximum of three consecutive years instead of the current restriction of maximum two consecutive valuations.²⁴

Other amendments to the REIT Guidelines proposed by the SC are:

(1) Property management

In attempt to improve efficiency, the SC proposes to allow REIT managers to take up equity interest in a property management company provided that 51% thereof is owned by a registered valuer pursuant to the Valuers, Appraisers and Estate Agents Act 1981.

(2) Internal management

The SC is considering amending the REIT Guidelines to allow REITs to be internally managed which may be in the form of a REIT owning the shares of the REIT manager or stapled REITs. This may effectively reduce costs where management fees for external management companies can be eliminated.

(3) Unlisted REIT

It is proposed that the offer of unlisted REITs be limited to sophisticated investors only which, under the current rules, may be offered to retail investors.

(4) Leverage limit

The SC has proposed to remove the option of a REIT to increase its leverage limit (currently provided under REIT Guidelines) of 50% of total asset value by way of ordinary resolution of unit holders' being obtained.²⁵

These changes seek to improve corporate governance and disclosure for REITs and effectively, the same for the REIT managers while minimising instances of "conflict of interests" between REIT managers and investors. The greater transparency should increase investors' confidence and enhance the attractiveness of REITs.

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²³ *Ibid*, at para 10.03

²⁴ *Ibid*, at para 10.07

²⁵ Paragraph 8.37 of the REIT Guidelines