AN OVERVIEW OF REGULATIONS THAT PROTECT REAL ESTATE STOCKS, REITS AND DERIVATIVE INVESTORS IN HONG KONG

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Abstract

All investors seek to make money. The repeated financial crises in recent years not only caused many people to lose their money; it also reminds us of the importance of financial regulations to reduce investors' losses due to improper business activities in a company or stock market. Together with London and New York, Hong Kong is one of the best known financial markets in the world. Real estate investment does not rest on direct investments in hotels, residential units, or the stock market. In this decade, Real Estate Investment Trusts (REITs) and derivatives provide a new source of investment. Yet, the huge volume of transactions coupled with increasingly complicated investment tools also implies that the rules of the legal system affect many people. While many European countries and China follow civil law systems, Hong Kong follows a common law system. Judge-made law forms one of the major sources of law and lays down the important rules on indirect real estate investment. The code of practice and legislation also provide a framework for investors and entrepreneurs.

Keywords: *Real Estate Derivatives, Real Estate Stock, REITs, Hong Kong*

1. Introduction

An increasing number of new financial tools are being developed to enable investors to make money. Gone are the days when the stock market was the only source of indirect real estate investment. Options, swaps, accumulators and Real Estate Investment Trusts (REITs) provide alternative ways to hedge losses in the stock market or act as alternative investment tools. Due to the smaller transaction costs, the existence of a public market place in the securitized market, higher liquidity, greater number of market participants, the indirect real estate market is generally more efficient than the direct one (Oikarinen *et al.* 2011). The quality of financial infrastructure relies on an effective legal framework (Herring and Chatusripitak 2000), Hong Kong's success as one of the highest rank financial centers also relies on this (MacNeil and Lau 2001). History also shows that appropriate legal regulations plays an important role in financial market, for example, overregulation and unfavourable tax treatment once resulted in a sluggish start of REITs in the U.S (Ulrich Schacht and Jens Wimschulte 2008). While previous pool of literature sheds light on causes of subprime financial crisis, few or no research paper has studied the regulations which protect indirect real estate investors. This study reviews Hong Kong's indirect real estate market statistics during financial crisis. It was found that Hong Kong REITs market's drop in prices was lowest among Australia, Japan, United Kingdom, United States, Singapore and

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France. The stock market ranked number two in the World during financial crisis. The paper then proposes the reasons behind her success through the lens of well-established rules and regulations. The research results provide useful insights to legal drafters when they attempt to draft relevant rules and regulations.

2. Indirect real estate investment tools

The merits of including real estate in a mixed-asset portfolio have been well documented. These include liability matching characteristics and risk diversification. Nevertheless, investment in the direct real estate market, which includes retail, residential, hotel and office properties suffers from obsolescence, lumpiness information asymmetries and co-ownership problems (i.e., unclear property rights) (Hoesli and Lekander 2008). In view of these drawbacks, many investors choose to invest in the indirect real estate market, such as property stocks, derivatives and REITs.

2.1 Real Estate Stocks

Stock owners can be viewed as owners of the company. Although stock ownership is often raised as one of the typical examples of the principal agent problem (when the owners and managerial staff are not the same person, managers may primarily pursue selfish interests, such as power, instead of running a profitable business), it brings many benefit to both firm owners and individual investors. From entrepreneurs' perspectives, a listing in the stock market is a good source of financing. Whereas borrowing money from a bank may involve huge expenses in the form of interest, money captured in the stock market does not require an expenditure on interest. On the other hand, the investors also view that it is a golden opportunity to invest in the real estate market with a small amount of money. Moreover, unlike direct real estate investment, which requires a lengthy transaction process, stocks can be bought or sold at any time.

Many of the Hong Kong listed firms are predominantly property businesses in nature, focusing on land, buildings, and estates. Many firms also conglomerate with other sectors, including trading, industrial and utility businesses, but have significant property interests on their balance sheets (Wallace and Naser 1995). Many real estate companies were listed as early as the 1970s, such as Cheung Kong Holdings, Sun Hung Kai Properties, and Sino Land. As China's economy grew quickly in the early 1990s, many China-based companies became listed in Hong Kong, such as China Overseas and China Resources.

During financial crisis, the listed property securities had not shrunk much in Hong Kong. In terms of market capitalization, Hong Kong property securities market ranked number 2 in the World (Newell and Razali 2009).

Country	Number of property securities	Market capitalization (US$ billion)	% of Asia market	% of global market	World ranking (by US$)
Hong Kong	126	175	41.4	18.5	2
Japan	163	107	25.3	11.3	3
Singapore	62	39	9.2	4.1	7
China	78	56	13.2	5.9	4
India	38	16	3.8	1.7	10
Taiwan	47	6	1.4	0.6	26

Table 1 Listed property securities markets in Asia in December 2008 (Newell and Razali 2009)

2.2 Real Estate Investment Trusts (REITs)

An REIT is a business trust, corporation or association which combines capital of investors to own and operate income producing real estate or to engage in real estate finance activities. REITs are analogous to mutual funds as they pool investors' funds (Daly 2008). The performance of REITs and that of the housing market are not directly comparable as the date which controls their prices come from different sources. A REIT's performance is measured in a way similar to those publicly traded stock (Monroe 2009).

In 1960, REITs were introduced in the USA to offer retail investors a possibility to invest in diversified property portfolios. A couple of countries have followed since then: Netherland (1969), Luxemburg (1988), Spain (1994), Italy (1994), Belgium (1995), France (2003) and lately the UK (2007) (Ulrich Schacht and Jens Wimschulte 2008). There are four different types of REITS currently (Rong and Trück 2010):

1. Mortgage trusts: the assets are invested in claims where interest is the major source of income.
2. Specialized trusts: investment in development and construction which involved in sale and lease-back arrangements.
3. Hybrid trusts: the assets invest in equity and mortgages, offering an advantage which offsets the interest income against depreciation of the property.
4. Equity trusts: the assets are invested in ownerships claims to different types of properties, e.g. commercial, industrial or residential property.

The first Hong Kong REIT, known as the Link, was launched by the Hong Kong Housing Authority in 2005 (Ooi *et al.* 2006). Since then, 7 REITs have become listed in the Hong Kong Stock Market (Table 2). To further understand the correlation between 7 REITs' prices in Hong Kong, daily REITs prices data from 6 November 2007 to 17 June 2011 was collected from Yahoo! Finance. The Pearson correlation results from SPSS 11 show that all the 7 REITs show a significant correlation with one another, i.e. most of the REITs fluctuate together (Table 3). That is collapse of one REIT may affect the other REITs in market badly.

Name of REIT	Hong Kong stock code	Description
The Link	823	The Link Real Estate Investment Trust was Hong Kong's first REIT. It includes a portfolio of 180 car park and retail facilities.
Regal Real Estate Investment Trust	1881	Regal REIT includes a portfolio of hotel properties in Hong Kong (Regal Real Estate Investment Trusts 2010).
Sunlight REIT	435	Sunlight REIT includes a diversified portfolio of 8 retail and 12 office properties in Hong Kong. The retail properties are located in regional transportation hubs, new towns and other urban areas with high population density, and the office properties are located in both core and decentralised business areas (Sunlight REIT 2010).
PREEF China Commercial Trusts	625	It includes Gateway Plaza, a Premium Grade A office complex located in Beijing (RREEF China Commercial Trust 2010).
Champion REIT	2778	Champion REIT owns 95.7% of Citibank Plaza, a modern steel and glass office complex that comprises Citibank Tower, a 47-storey building, and ICBC Tower, a parking garage for 555 vehicles and a retail podium (Champion REIT 2010).
Prosperity REIT	808	The portfolio includes properties with direct mass transportation network access in Hong Kong. These properties include Prosperity Place, The Metropolis Tower, Prosperity Centre, Prosperity Millennia Plaza, Harbourfront Landmark, Trendy Centre and New Treasure Centre (Prosperity REIT 2010).
GZI REITs	405	Champion REIT was spun off from Great Eagle Holdings, Its principal asset includes a stake in Citibank Plaza (GZI REIT Assessment Management Limited 2010).

Table 2 Real Estate Investment Trusts in Hong Kong

		LINK	REGAL	GZI	Prosperity	CHAMPION	SUNLIGHT	PREEF
LINK	Pearson Correlation	1	.870(**)	.952(**)	.868(**)	.817(**)	.801(**)	.847(**)
	Sig. (2-tailed)	.	.000	.000	.000	.000	.000	.000
	N	893	892	893	893	893	893	891
REGAL	Pearson Correlation	.870(**)	1	.924(**)	.944(**)	.953(**)	.955(**)	.889(**)
	Sig. (2-tailed)	.000	.	.000	.000	.000	.000	.000
	N	892	892	892	892	892	892	891
GZI	Pearson Correlation	.952(**)	.924(**)	1	.907(**)	.891(**)	.868(**)	.903(**)
	Sig. (2-tailed)	.000	.000	.	.000	.000	.000	.000
	N	893	892	893	893	893	893	891
Prosperity	Pearson Correlation	.868(**)	.944(**)	.907(**)	1	.969(**)	.953(**)	.854(**)
	Sig. (2-tailed)	.000	.000	.000	.	.000	.000	.000
	N	893	892	893	893	893	893	891
CHAMPION	Pearson Correlation	.817(**)	.953(**)	.891(**)	.969(**)	1	.962(**)	.863(**)
	Sig. (2-tailed)	.000	.000	.000	.000	.	.000	.000
	N	893	892	893	893	893	893	891
SUNLIGHT	Pearson Correlation	.801(**)	.955(**)	.868(**)	.953(**)	.962(**)	1	.821(**)
	Sig. (2-tailed)	.000	.000	.000	.000	.000	.	.000
	N	893	892	893	893	893	893	891
PREEF	Pearson Correlation	.847(**)	.889(**)	.903(**)	.854(**)	.863(**)	.821(**)	1
	Sig. (2-tailed)	.000	.000	.000	.000	.000	.000	.
	N	891	891	891	891	891	891	891

** *Correlation is significant at the 0.01 level (2-tailed).*

Table 2 Stock price correlations between 7 REITS in Hong Kong (Author's SPSS results)Fortunately, all the REITs in Hong Kong perform quite well during financial crisis. She dropped less than many other countries' REITs which include France, Japan, the U.S., Singapore, the U.K. and Australia.

Countries	Impact of financial crisis on REITs market	Rank of change (least =1, most=7)
Hong Kong	-28.50%	1
France	-36.80%	2
Japan	-37.10%	3
US	-38.30%	4
Singapore	-56.10%	5
UK	-59.10%	6
Australia	-64.80%	7
Global	-45.00%	

Table 3 Impact of financial crisis on REITs market (Newell and Razali 2009)

2.3 Real Estate Derivative

A "derivative" refers to an investment tool whose value is determined by, or derived from, a bundle of assets or the value of another asset. Financial derivatives can appear in a variety of forms, including futures and swaps, call and put options and more exotic complex instruments (Clayton 2007). Derivatives include swaps, options and so on. Many people nowadays associate derivatives with infamous financial events (e.g., the subprime financial crisis in 2007-2009) and scandals resulting from speculative use of derivative and hugely leveraged financial instruments. Joseph Stieglitz, a Nobel economics prize-winner, suggests that their use should be outlawed. Nevertheless, they are in no doubt an excellent, indispensable tool of risk management. Myron Scholes, another Nobel laureate, says a complete ban would be a luddite response which takes financial markets back decades (Suetin 2011).

The underlying assets in real estate derivative are those property related indicies, mortgage etc. Real Estate derivatives have many uses, e.g. hedging, portfolio diversification or get exposure to foreign countries' real estate without buying physical property (Fabozzi *et al.* 2010). Real estate derivatives witness tremendously growth in the UK and Europe recently. They were introduced since the early 1980s with the establishment of the Investment Property Databank (IPD) index in the U.K (Ong and Ng 2009). Two main types of property derivatives available in the UK now are total return swaps based on IPD indices and property index certificates (Patel and Pereira 2008). In the U.S., Credit Suisse First Boston LLC teamed up with NCREIF in an attempt to create the first US real estate investment derivatives market in mid 2005 (Ong and Ng 2009).

In Asia, Hong Kong is the first city which offers real estate indexes for derivative trading. Developed jointly by GFI Colliers HK and the University of Hong Kong in November 2006, the monthly indexes cover the residential markets in Hong Kong Island, New Territorries and Kowloon in Hong Kong (Ong and Ng 2009).

3. Laws and regulations that govern real estate stocks, derivatives and REITs

In Hong Kong, financial investors are protected by legislative rules and judge-made law (common law). Because Hong Kong was once a colony of the United Kingdom, many of these rules are rooted in UK law. Apart from that, the Basic Law also provides useful insights on financial regulations.

3.1 Common Law in Hong Kong: jurisprudence and legal reasoning

The common law is 'common' in the sense that it is generally adopted in English terrain. Unlike the civil law system, the common law system is less influenced by Roman law. The common law system gives a great precedential weight to common law (case law), in which judges make judgments according to the doctrine of precedent of courts together with the statute statements. Hence, there is a wide range of variety of sources of law. Under the common law system, there are three major primary sources: statutes (laws enacted by the legislature, which is given authorisation of the government, also known as legislation), case law (judge-made law), and customary law. Alternatively, common law can be classified into two types, public and private. The former includes criminal law, administrative law and constitutional law, concerning the public bodies or officials to *'protect public decision makers from risk …or challenges made by those who use judicial process as a means of political point'* (Mcleod 2009). Private laws involve the dealings of private parties. Examples are contract and company law, which are common in indirect real estate transactions. Finally, some customs are also defined as law, i.e., customary law. Other secondary sources of law, such as directories and journals, are not treated as real law but as an interpretation.

The common law is different from the civil law system in the sense that it is '*part of the law which is contained in the decision of courts rather than having been enacted by the parliament*'(Mcleod 2009). In other words, judges have to analyse the statutes (enacted by legislation), understand the overall picture of the case, then apply the various principles, with less sensible ones rendered void while more sensible ones are adopted in the judgment. If necessary, precedential judgment is also considered. The ultimate court decision will become a case law that is binding to future cases, a principle known as 'stare decisis'. One should note that 'equity' has been incorporated into common law to provide non-monetary remedies, e.g., injunctions.

In the common law regime, jurisprudence is '*the theoretical analysis of legal issues at the highest level of abstraction*'. Therefore, jurisprudence should be understood before the discussion of common law (Martin 2009). One of its important emphases is American (Legal) Realism, with O.W. Holmes (d. 1935) as its founder. This stream of academics focuses on 'law in action' rather than 'law in book'. In other words, the law should be determined by practices in the real world. '*Behind any explicit formulation of judicial reasoning there lies an implicit attitude on the part of the judge*' (Mcleod 2009, p.4). A judge's personal interpretations of a case, previous case laws and statutes together affect his decision.

Because judges' decisions influence the functioning of the law by augmenting case law, some criticisms arise. Common law is undemocratic in the sense that judges, who can alter the law, are not elected by the public. Additionally, unfairness may result because judges may be biased in particular conditions. These situations can be regarded as the drawbacks of common law (Wesley-Smith 1998). Because the jurisdiction can be influenced by the precedential judgment, legal reasoning, which is syllogistic, is involved. By comparing the statement of law (major premise) and statement of fact (minor premise), legal outcomes can be reasoned. There are three legal reasoning methods: analogy, inductive reasoning, and deductive reasoning. Analogy means that, if A has numerous similarities with B, then A and B should be similar to each other in some way. In law, similar cases should be judged in a similar way so that a similar result is obtained and thus fairness is maintained. This is also known as 'stare decisis' as mentioned before. The rationale for inductive reasoning is that the court observes different cases and then works out a principle for general application of the law. Deductive reasoning means evaluating a proposition with reasoning by applying the established principles of logic. Its rationale flows from general to specific conditions (Mcleod 2009).

3.2. Regulation of Hong Kong real estate derivatives, REITs and stocks

Many people argue that the failure of large complex financial institutions in 2007-2009 was the results of unprepared legal and regulatory systems (Arner and Norton 2009). There is no doubt that maturity and transparency in many Asian real estate markets have improved considerably since the Asian Financial Crisis in 1997 (Ooi *et al.* 2006). During the global financial tsunami, Hong Kong's real estate stock and REITs perform better than many other overseas markets during financial crisis. How do Hong Kong legal rules and regulations protect investors?

3.2.1 Regulation of real estate stocks

As share price equals the discounted value of expected cash flows (Nwaeze 2000; Ambrose and Bian 2010), regulations which affect the future cash flows of stock owners also play an important role in investment decisions. In Hong Kong, there are legislations which govern the property stocks trading.

Insider dealing occurs when a corporation or an individual that is directly or indirectly connected to a listed corporation uses information about that corporation to buy or sell securities with the aim to earn more than they would have without knowing this information. To ensure a level playing field for all participants in the market, the Securities (Insider Dealing) Ordinance (SIDO), and the Securities (Disclosure of Interests) Ordinance (SDIO) were implemented on September 1, 1991. Insider dealing, therefore, is a criminal offence in Hong Kong. The Insider Dealing Tribunal is empowered to impose orders to penalise insider dealers and inquire into insider dealing cases. A person who had been identified as an insider dealer may be required to pay the loss avoided by the insider dealing or an amount not exceeding the profit he/she made to the government. He/she may also be prohibited from assuming a position as a liquidator, director, manager or receiver of a company for a period of up to five years and/or penalised for an amount of up to three times the profit made. Any persons who contravene the orders or the investigation made by the Tribunal may be liable for a term of imprisonment of one year and a fine of up to $200,000. The SDIO requires the disclosure of interests for substantial directors and shareholders as well as chief executives of corporations. Regardless of where the companies are incorporated, the Ordinance is applicable to all companies listed on the Stock Exchange of Hong Kong (SEHK). A substantial shareholder is defined as anyone holding at least 5% of the share capital of a corporation listed on the SEHK. Moreover, chief executives and directors of a listed company are obligated to declare any interest in debentures or shares in the listed company or any associated corporation and their disposal or acquisition. Any shares or debentures owned by any children under the age of 18 or spouses of directors must also be disclosed. Both substantial shareholders and directors are required to report any alterations in their interests to the SEHK within five working days. If a listed company fails to comply with the Ordinance, the officer concerned would be liable for a fine of $2000. A further $200 fine per day must be paid in the case of continuing offences. An individual who makes a notification that is false in material particulars or who fails to make a timely notification is subject to a term of imprisonment of up to two years and a fine of up to $100,000 (Cheuk *et al.* 2006).

Unlike the stock market in Japan and the US where securities law prohibits foreign securities being offered locally unless they are registered and registration is a process akin to listing on the local exchange, there is no such restriction in Hong Kong. Furthermore, Hong Kong's market is quite transparent as the authorities do not intervene in stock and bond markets via 'price-keeping operations (the Japanese broking houses may do so) or market participants try to manipulate the market for commercial or political gain (De Brouwer 2003).

3.2.2 Regulation of Real Estate Investment Trusts (REITs)

Currently, all REITs in Hong Kong are formed under section 104 of the SFO (Chapter 571 of the Laws of Hong Kong). Some regulations control the parties that can invest in REITs. Under section 8(2)(c) of Schedule 1, Mandatory Provident Fund Schemes (General) Regulation, a constituent fund (CF) may invest no more than one tenth of its NAV into REITs as approved by the SFC under the REIT Code. The Occupational Retirement Scheme Ordinance (ORSO) states that there is no explicit prohibition of SFC-authorised REIT acquisition subject to the Code on Pooled Retirement Funds (Department of Justice 2011).

On 30th July 2003, Hong Kong's final Code on Real Estate Investment Trusts was released. It permits Hong Kong REITs to be managed either externally by an external third party or internal party, i.e. parties of REIT sponsor. The manager must employ property management staff with at least 5 years experience in managing real estate and at least 2 officers with at least 5 years experience in managing collective investment schemes (Lockhart and Turl 2003).

The following Table compares REITs in Hong Kong and other places. As gearing is critical for REITs to have flexibility in borrowing, a conservative approach adopted during financial crisis plays an important role in hedging against risks. Unlike the other places such as North America, Singapre and Australia where there are no limit on gearing, Hong Kong is quite conservative in setting a borrowing limit of 35% (Wang *et al.* 2009).

	Hong Kong	Other places
Gearing	There is borrowing limit at 35%	There is no limit in North American, Singapore, Australia, Japan and France. In Netherland, there is no more than 60%
Management company	At least 5 years' experience in managing property funds or employment of persons with at least 5 years	Singapore has similar requirement.
Investment restrictions	There is no restriction on overseas investment.	The same principle applies in Singapore, the U.S., Canada, the Netherlands and France.

Table 4 Financial regulations of REITs in Hong Kong and other places (Wang et al. 2009)

3.2.3 Regulation of Hong Kong's Derivatives

As one of the major financial centres in the world, the emergence of derivative products has led to the question of whether Hong Kong's regulators should take the initiative in legislation reform. Partly for historical reasons, there is no single unified regulatory framework that applies to all derivative products. Hong Kong derivatives are regulated in three principal ways. The first type of regulation refers to laws that have been designed specifically for particular types of derivatives. For instance, under the Securities and Futures Ordinance (SFO), the trading of futures contracts is a regulated activity. Second, when derivatives are embedded in another investment instrument, their trading may be regulated by the regulations that are applicable to that particular instrument. For instance, a derivative may be embedded in a bond or note, such as an equity-linked note. Because an equity-linked note is regarded as a security, engaging in such derivatives trading constitute a regulated activity of securities dealing. Third, a derivative may contain certain characteristics and features similar to certain pre-existing products that have already been covered by the regulations applicable to these products; e.g., parties who are entering into longevity derivatives, credit derivatives or weather derivatives have to consider whether products as such constitute insurance. An insurance business must be regulated by the Insurance Companies Ordinance. Apart from the above-mentioned legal rules and regulations, similar to the US Commodity Exchange Act, the margin requirements and short sales restrictions of the Securities Exchange Act of 1934 which ruled out illegal speculation activities (Stout 1999), the Gambling Ordinance in Hong Kong requires the consideration of whether the derivatives issued are illegal gambling contracts (Department of Justice 2011).

4. Conclusion

Real estate derivatives and REITs are new investment tools, and Hong Kong's investors and legislators are still in the discovery stage regarding these. Common law has its principles and issues and can be classified into different types and sources. It has some drawbacks as well as benefits as compared to the civil law system; for instance, it is more consistent because similar cases are given similar judgments as a result of considering the precedents of the courts. In view of these advantages and the trend of globalisation, a mix of common law and civil law systems may be observed. Besides, because REITs and derivatives are relatively new financial products, business activities as such are governed mainly by rules that are applied to other similar products in Hong Kong. The subprime financial crisis, however, underscored the importance of appropriate regulations. It is expected that regulations will be designed specifically for these tools.

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