



Hong Kong

July 2016

## LATEST GUIDANCE ON POOLED PROPERTY ARRANGEMENTS AND CROWDFUNDING PROPERTY INVESTMENTS

The Securities and Futures Commission (**SFC**) updated its FAQs on “Offers of Investments” under the Securities and Futures Ordinance (**SFO**) in June 2016 to include a new Appendix 1 providing guidance on collective investment schemes (**CIS**) involving interests in real property, particularly the features of real estate projects that may constitute a CIS and the consequences that may arise. The amendment of the FAQs reflects the SFC’s increased focus on offers of investments involving real property.

A further indication of the SFC’s renewed focus on real estate investment arrangements is the recent case of HKSAR v IPFUND Asset Management Limited and Sin Chung Yin DCCC 23/2015 in which the SFC sought to prosecute IPFUND and its director for carrying on unlicensed dealing in securities in relation to a property management scheme. The District Court however acquitted the defendants despite finding that IPFUND was carrying on a business in operating 16 CIS. This was because the investments were acquisitions of shares in Hong Kong incorporated private shell companies which held the properties in question. The definition of “securities” in Schedule 1 to Part 1 of the SFO excludes the securities of private companies: there was therefore no “dealing in securities”.

Nevertheless, it is important to be aware that if the investments under real estate investment arrangements constitute shares in a Hong Kong public company or a non-Hong Kong private or public company, promoting and/or marketing the arrangements may well constitute an offer of interests in a CIS which must be authorised by the SFC unless an exemption is available (for example because the offer is only to “professional investors”

within the meaning of Schedule 1 to the SFO or is made by way of private placement). The recent UK Supreme Court case, *Asset Land v Financial Conduct Authority* [2016] UKSC 17,<sup>1</sup> held that “land banking” (a type of pooled property investment arrangement) constitutes the UK regulated activity of “operating a collective investment scheme” for which Financial Conduct Authority (**FCA**) authorisation is required. There is no comparable exemption under the relevant UK law for offers of private company securities.

The following is a summary of:

- the provisions of the SFC’s latest guidance on CIS involving interests in real property;
- the position in relation to offers of shares in Hong Kong private companies; and
- the UK Supreme Court case referred to above.

### Appendix 1 of the FAQs on Offers of Investments under the SFO: CIS Involving Interests in Real Property

The following is a summary of the provisions of the new Appendix on CIS involving property interests.

<sup>1</sup> <https://www.supremecourt.uk/cases/docs/uksc-2014-0150-judgment.pdf>

## ***The Regulation of CIS in Hong Kong***

### ***Q1. What is a CIS?***

A CIS is defined broadly in Schedule 1 to the SFO and typically has the following four elements:

- a) it involves arrangements in respect of any property;
- b) investors do not have day-to-day control over the management of the property even if they have the right to be consulted or to give directions about the property's management;
- c) the property is managed as a whole by or on behalf of the person operating the arrangements, **and/or** the contributions of the investors and the profits or income from which payments are made to them are pooled; and
- d) the purpose or effect of the arrangements is for the investors to participate in or receive: (i) profits, income or other returns, or payments from the acquisition, holding, management or disposal of the property, or (ii) payments or other returns from: the acquisition, holding or disposal of, the exercise of any right in, the redemption of, or the expiry of, any interest in the property.

### ***Q2. How is a CIS regulated in Hong Kong?***

The SFC regulates the promotion and offering of interests in a CIS to the Hong Kong public under the SFO. It is an offence under the SFO to issue any marketing material which is or contains an offer to the Hong Kong public to acquire an interest or participate in a CIS, unless it has been authorised by the SFC or exemption under section 103 of the SFO applies. Promoting interests in a CIS may also require an SFC licence if it is done as part of the carrying on of a business.

### ***Features of real estate projects that may give rise to a CIS***

### ***Q3. Why would the sale of real estate amount to a sale of interests in a CIS?***

The term "CIS" is defined broadly in Schedule 1 to the SFO to cover "arrangements" in respect of **any "property"**. "Property" is widely defined under the SFO to include land or any estate in land so that real estate in Hong Kong or overseas will constitute "property". Thus if arrangements in relation to real property have the characteristics referred to in Q1 above, they would be a CIS.

### ***Q4. What types of real estate and/or real estate projects may be a CIS?***

Whether a sale of real estate and/or a real estate project constitutes a sale of interests in a CIS will depend on the facts including how the arrangements involving real estate are operated and how the property is managed under the arrangements. Generally, real estate projects involving interests in hotel/holiday resorts etc. are more likely to be CIS because they're more likely to need to be managed on behalf of investors. Buy to let and Buy and leaseback could also be CIS as they often involve a centralized letting and management service.

### ***Q5. If investors own the individual units in a real estate project where: the units are rented, the rent is pooled; and a manager makes decisions about how to rent units, are the arrangements likely to be a CIS?***

Where units are rented and the rent is pooled (e.g. the investor receives a proportion of the total income from all the units equal to the fraction their unit accounts for out of all the units), and a manager makes decisions about how the units are rented, in terms of to whom the units are rented and on what terms and whether any unit should be left unlet, the arrangement is likely to amount to a CIS. This is because:

- a) the project involves arrangements in respect of real property, even though investors may have rights to their own units;
- b) the centralised letting service means that owners of units do not have day-to-day control over the management of the property;
- c) the property is managed as a whole by the operator of the arrangements; and
- d) the arrangements' purpose is for investors to receive income from the property.

### ***Q6. If there is no pooling of contributions and profits or income, would it still be a CIS?***

The arrangements may still be a CIS because if the property is managed as a whole by/on behalf of the person operating the arrangements and the arrangements have the other elements referred to in Q1.

**Q7. What does the “Day-to-day control over the management of the property” mean?**

Routine, ordinary, everyday management and operational decisions, not just the legal ability to decide what is to happen. Focuses on whether investors can really make management decisions. Arrangements may still be CIS even when investors do not have day to day control in practice.

**Q8. If some (but not all) investors have day-to-day control, will arrangements involving real property interests still be a CIS?**

Yes. ALL investors must have day-to-day control over the management of their properties for a scheme not to be a CIS. Even where just one investor does not have day-to-day control, the scheme could still be a CIS.

**Q9. If investors have a right to be consulted or to give directions about the management of their units, does this mean they have “day-to-day” control?**

No, a right to be consulted or give directions is not enough to stop the scheme being a CIS.

**Q10. If investors owning different units in the same project appoint the same property agent to lease their units for them, would the property agent be regarded as managing these units as a whole and would the arrangements be a CIS?**

Whether a property is managed as a whole depends on the facts. If the individual investor only engages the agent to carry out administrative steps to lease out their units according to the terms specified under the relevant agency agreements, and the individual investors would direct and make key profit-generating decisions, the property agent would not generally be regarded as managing the units.

**Q11. Would a project be regarded as being managed as a whole by a property managing agent where: (a) a managing agent manages the project and arranges leases between investors and tenants; (b) the investor chooses the tenant and decides the lease terms; (c) the agent runs the project and relationships with tenants including**

**collecting rent, arranging repairs and insurance, cleaning and security; and (d) the individual investor receives the rent attributable to his/her unit?**

A project would not generally be regarded as being managed as a whole if the investor made decisions on key matters relevant to the investor’s profit (e.g. the identity of the tenant, the terms of the lease and the amount of rent). In this case, the project would be regarded as managed on an individual basis as each unit would be managed taking into account each investor’s interests. If a managing agent makes decisions indirectly related to profit (for instance cleaning and maintaining the common areas) the project would probably still not be ‘managed as a whole’ by the agent.

**The consequences of promoting or offering interests in a CIS involving real property**

**Q12. What are the consequences of offering interests in CIS involving real property to the public in HK?**

It is an offence under section 103 of the SFO to issue marketing material which is or contains an offer to the Hong Kong public to acquire an interest or participate in a CIS involving real property unless the offer has been authorised by the SFC or is exempt. The offence carries maximum penalties of a fine of HK\$500,000 and three years’ imprisonment. Making a fraudulent or reckless misrepresentation to induce another person to invest in a CIS is also an offence under Section 107 of SFO for which the maximum penalties are a fine of HK\$1,000,000 and 7 years’ imprisonment.

**Q13. What are the consequences of promoting interests in a CIS involving real property?**

Promoting interests in a CIS without being licensed to do so is an offence under Section 114 of the SFO for which the maximum penalties are a fine of HK\$5,000,000 and 7 years imprisonment.

**Q14. Is SFC authorisation needed if only professional investors invest?**

The issue of CIS marketing material in relation to a CIS that is or is intended to be sold only to “professional investors” within the definition in Schedule 1 of the SFO is within the exemptions under section 103 SFO.

## **Q15. What has to be done to get SFC authorisation?**

Applications for authorisation can be refused by the SFC where it considers it to be not in the interest of the investing public.

A CIS investing in real property seeking SFC authorisation is generally required to comply with the Code on Real Estate Investment Trusts, including:

- the CIS must be listed on the Stock Exchange of Hong Kong Limited;
- the CIS manager must be SFC licensed or be licensed by the regulator of an overseas regime acceptable to the SFC;
- there must be a trustee; and
- the assets of the CIS must be segregated and held in trust.

## **Q16. If I promote interests in a CIS investing in real property to professional investors only, does that breach the SFO?**

Even if the intention is to sell interests in a CIS to professional investors, you may still be carrying on a business which needs an SFC license. If you don't have an SFC licence, you may still be committing an offence under section 114 of the SFO.

### **Shares in Private Hong Kong Companies**

The FAQs do not mention the SFC's unsuccessful attempt in the case of HKSAR v IPFUND Asset Management Limited and Sin Chung Yin DCCC 23/2015 to prosecute IPFUND and its director for carrying on unlicensed dealing in securities in relation to a property management scheme. The Reasons for Verdict were provided only in Chinese<sup>2</sup>, but for an unofficial English translation please click here <http://www.charltonslaw.com/newsletters/hong-kong-law/en/2016/342/Reasons-for-verdict.pdf>.

Despite the District Court judge's finding that IPFUND was carrying on a business in operating 16 collective investment schemes, the defendants were acquitted because the investments were acquisitions of shares in Hong Kong incorporated private shell companies which held the properties in question. The facts, very briefly, were that:

- Funds contributed by the investors were pooled for use in purchasing commercial properties in Hong Kong.
- Upon the sale of those properties, part of the profit earned would be distributed among the investors in proportion to their contribution towards the purchase price, and IPFUND received consultancy fees based on profits earned from the trading of these commercial properties.
- IPFUND and Sin were accused by the SFC of carrying on a business, or holding out as carrying on a business, in a regulated activity in dealing in securities without a licence in contravention of section 114 of the SFO on the basis that the securities in question were CIS.

This was the first indictable prosecution for an offence under section 114 of the SFO. It was also the first court decision to consider the scope of the regulated activity "dealing in securities" in the context of shares in a private Hong Kong company.

The implications of the decision are however limited given that:

- "Private company" for the purposes of the definition of "securities" means a Hong Kong private company incorporated under section 11 of the Companies Ordinance (Cap 622) or its predecessor ordinance. The shares of a company which is private under the laws of another jurisdiction (e.g. the British Virgin Islands or the Cayman Islands) would be within the definition of securities. Hence the structure used in the IPFUND case could not be used for other jurisdictions.
- The decisions of the Hong Kong District Court are not binding and it would thus be open for a different trial judge to reach a different conclusion on the same set of facts.

### **The UK Supreme Court case *Asset Land v Financial Conduct Authority* [2016] UKSC 17**

The recent UK Supreme Court case *Asset Land v Financial Conduct Authority* [2016] UKSC 17<sup>3</sup> establishes that "land banking" (a type of pooled property investment arrangement) constitutes operating a collective investment scheme.

The facts were that:

2 [http://legalref.judiciary.gov.hk/lrs/common/search/search\\_result\\_detail\\_frame.jsp?DIS=103729&QS=%2B&TP=RV](http://legalref.judiciary.gov.hk/lrs/common/search/search_result_detail_frame.jsp?DIS=103729&QS=%2B&TP=RV)

3 <https://www.supremecourt.uk/cases/docs/uksc-2014-0150-judgment.pdf>



- The proceedings related to Asset Land's sales of individual plots of land at 6 possible development sites in the UK. Asset Land purchased parcels of land which it subdivided into smaller plots which were sold to investors on the basis that Asset Land would arrange for the entire parcel to be re-zoned and sold to developers as a profit.
  - The FCA brought charges against Asset Land for carrying on the regulated activity of "operating a collective investment scheme" without being authorised to do so under section 19 of the Financial Services and Markets Act 2000 (FSMA). There is no exclusion which would prevent shares in a private company from constituting interests in a collective investment scheme.
  - The definition of collective investment scheme is essentially the same as the Hong Kong definition, the key elements being:
    - a) arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements to participate in or receive profits or income from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income;
    - b) the persons participating in the arrangements do not have day-to-day control over the management of the property, whether or not they have the right to be consulted or to give directions;
    - c) the arrangements must have the following characteristics:
      - the contributions of the participants and the profits or income out of which payments are to be made to them are pooled; and
      - the property is managed as a whole by or on behalf of the operator of the scheme (section 235 of the FSMA).
- Land should achieve a sale of the site (or a substantial part of it) after it had sought to enhance its value so that the price that it would attract by improving the prospects for housing development (through the site being re-zoned, if not granted planning permission), and the price paid for it would be shared between the owners.
- The court rejected the defence's argument that as investors had different understandings of what was planned, the necessary "arrangements" did not exist. It was sufficient that all investors had a "shared understanding of the essential features of the schemes". It was enough that the understanding was reasonably based on what they were told by the company's representatives, whether or not the company had any intention of acting in accordance with them.
  - The court rejected the argument that the company and investors could not be found to have entered into arrangements that were inconsistent with the contracts they had signed.
  - Each site of the relevant property was found to be acquired by Asset Land on the basis that none of the investors had any control over the "site as a whole". The same view was reached even if the relevant property was treated as the individual plots given that the key feature of management was to enhance the development status of the land and sell it, and this was to be done by Asset Land.
  - The essential nature of the schemes was that the plots were investments and they were to be sold as part of the site after their value had been enhanced through planning permission or the prospect of development after re-zoning. "Management" of the property meant management directed to the "long term goals". It was obvious that only Asset Land would deal with the management matters and the structure as a whole.

## The decision of the UK Supreme Court

The court found in favour of the FCA on the basis that:

- Asset Land's brokers and investors made arrangements when plots were marketed and investors paid a deposit to acquire land. The object of the arrangements was that Asset

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