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REITs:
BUILDING
DIVIDENDS
AND
DIVERSIFICATION®

September 13, 2016

VIA: http://surveys.sc.com.my/s3/Public-Consultation-REITs-Guidelines and juwita@seccom.com.my

Securities Commission Malaysia
3, Persiaran Bukit Kiara
Bukit Kiara
50490 Kuala Lumpur

Re: Public Consultation Paper 3/2016: Proposed Amendments to Guidelines on Real Estate Investment Trusts and Streamlining of Post-Listing Requirements for Listed Real Estate Investment Trusts with Listed Corporations (the REIT Consultation Paper)

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts (NAREIT)® greatly appreciates the opportunity to provide its comments on the Consultation Paper that proposes improvements to the Malaysian REIT[1] rules in order to meet the Malaysian Securities Commission (SC)'s objectives of facilitating growth by expanding the scope of permitted activities that can be undertaken by a Malaysian REIT (MA-REIT); enhancing governance requirements; and, improving efficiency through streamlining of post-listing requirements for listed MA-REITs with those for listed corporations.

NAREIT is the National Association of Real Estate Investment Trusts®, the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. We represent a large and diverse industry including equity REITs, which own commercial properties, mortgage REITs, which invest in mortgage securities, REITs traded on major stock exchanges, public non-listed REITs and private REITs. U.S. REITs collectively own nearly $2 trillion of real estate assets and, by making investment in commercial real estate available in the form of stock, our REIT members enable all investors – importantly, small investors – to achieve what, once, only large institutions and the wealthy could.

As an initial matter, NAREIT's responses to relevant headings in the REIT Consultation Paper are set forth below. 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

[1] This letter will refer to a Malaysian REIT as an "MA-REIT." The term "MREIT" is not used because that acronym is commonly used in the U.S. to refer to a U.S. mortgage REIT.

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develop or purchase properties. Accordingly, and as further set forth below, we generally believe that it would be preferable for the SC 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 Malaysia's REIT industry, especially with regard to self-managed companies.

EXECUTIVE SUMMARY

As further set forth below, NAREIT generally supports the motivations underlying the SC's proposals to strengthen corporate governance standards and align incentives between Malaysia REIT managers and unitholders. First, NAREIT supports allowing MA-REITs to engage in development generally and unlimited development for their own account. Second, NAREIT recommends that Malaysia allow the market to determine the appropriate leverage for MA-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. Third, NAREIT urges the SC to conform corporate governance rules for REITs to those for non-REITs. Finally, NAREIT urges Malaysia to take the opportunity to allow MA- REITs to be either externally or internally managed through use of their own employees, rather than solely through a stapled stock structure or through ownership of the REIT manager.

DISCUSSION

I. Background: U.S. REITs

A. <u>Requirements</u>

By way of background, the U.S. experience may be instructive. In order to remain real estate-focused, U.S. REITs must satisfy an annual income test and a quarterly asset test. Annually, at least 75% of a REIT's income must be from real estate sources such as "rents from real property" and interest on loans secured by mortgages on real property, gain from the sale of real property held for investment, dividends from REITs and gain attributable to the sale of REIT shares, abatements and refunds of taxes on real property, and other related income. Furthermore, at least 95% of a REIT's income must be derived from passive sources, such as those sources included in the 75% test, as well as dividends and non-real estate interest. In connection with the types of permissible assets, U.S. tax law requires that at the end of each calendar quarter, at least 75% of the value of a REIT's total assets be represented by "real estate assets," cash and cash items (including receivables) and Government securities.

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 confiscatory 100% rate. 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% (scheduled to be 20% beginning in 2018) of the U.S. REIT's gross assets.

Specifically, no corporate level 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 20% 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.[2] Further, these objective tests are only a "safe harbor," and a REIT is not assessed the 100% tax if it can demonstrate that it did not act as a dealer based on the surrounding facts and circumstances.

B. <u>U.S. REITs Have Benefited Investors and the Economy</u>

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 2015, U.S. Securities and Exchange Commission (SEC)-registered REITs distributed more than $51 billion to their shareholders.

Congress' vision has been realized: as of July 29, 2016, over 200 publicly traded REITs had a total equity market capitalization of over $1.1 trillion. 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 July 29, 2016 of the

[2] In December 2015, the U.S. Congress modified this test so that, in any taxable year, the aggregate adjusted bases and the fair market value of property sold during the three taxable year period ending with such taxable year may not exceed 10% of the sum of the aggregate adjusted bases or the sum of the fair market value of all of the assets of the REIT as of the beginning of each of the three taxable years that are part of the period.

S&P 500 stock index was 6.08%, while that of all equity (property-owning) REITs was 11.72%. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public equity REITs are around 33%, 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.[3] Simply 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. SC Proposals

A. NAREIT Supports Allowing MA-REITs to Engage in Development Generally and Unlimited Development for Their Own Account

1. SC Proposals and Issues for Consultation

Under current Malaysia law, MA-REITs are currently permitted to acquire properties under construction valued at up to 10 per cent of their total asset value (after the acquisition), and they are not permitted to undertake property development activities or acquire vacant land. This restriction was intended to ensure that MA-REITs are not exposed to the risks associated with property development activities, given their nature as companies that primarily invest in real estate with the aim of providing investors with returns derived from recurrent rental income.

The SC proposes to allow a REIT to undertake development activities up to 15% of its "enlarged total asset value in aggregate," but only if: i) a MA-REIT holds the completed property for at least two years from the date of completion (*i.e.* upon attainment of the certificate of fitness) of the property development;[4] and, ii) in the event that an MA-REIT wishes to dispose of the completed property during the 2-year holding period, it must seek its trustee's consent and obtain approval from unit holders by way of a special resolution. Also, the SC proposes that: i) "Property development activities" be defined as "the construction or re-development of a building or the extension to an existing building", without including renovation, refurbishment or retrofitting costs; and, iv) the threshold on minimum investments in real estate and/or single purpose companies to be increased from the current requirement of 50% to 75% of a REIT's total asset value. As a result, an MA-REIT's minimum investments in real estate and/or single purpose companies would have to be at least 75% of its total asset value at all times. This last change is to ensure that MA-REITs have a substantial portion of their investments in income-generating real estate.

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[3] Frank Packer, Timothy Riddiough, and Jimmy Shek, *Securitization and the Supply Cycle: Evidence from the REIT Market*, 39 J. PORTFOLIO MANAGEMENT 134, 135 (2013).

[4] This is to ensure that property development activities are conducted with the objective of enhancing the income-generating capacity of MA REITs for the benefit of unit holders and not for purposes of development and subsequent disposal.

Issues for Consultation (Proposal 1)

Question 1: Do you agree with the SC's proposal to allow REITs to undertake property development activities by way of redeveloping their existing properties or acquiring vacant land for purpose of development? Please provide specific reasons for your views.

Question 2: Do you agree with the proposed aggregate limit of 15% of a REIT's total enlarged asset value for property development, property under construction and acquisition of vacant land for development? Please provide specific reasons for your views. If you disagree with the proposed limit, please indicate what you consider as appropriate together with the rationale thereof.

Question 3: Do you agree with the SC's proposal for a REIT to be required to hold the completed property for at least two years from the date of completion of the property development? Please provide specific reasons for your views.

Question 6: Do you agree with the proposed definition of "property development activities"? Please provide specific reasons for your views.

Question 7: Do you agree with the SC's proposal that REITs must have at least 75% of their total asset value invested in income-generating real estate and/or single purpose companies? Please provide specific reasons for your views.

2. NAREIT Recommendations

The REIT Consultation Paper would limit the extent to which an MA-REIT could develop properties for its own account to no more than 15% of the REIT's assets, and then only if the completed property is held for and leased for at least two years after completion.

NAREIT agrees that flexibility in respect of property development investments and related activities should be introduced for MA- REITs. Specifically, NAREIT recommends that MA-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.

NAREIT's concern is that the SC proposal requiring an MA-REIT to hold a property for at least two years may inappropriately restrict an MA-REIT from maximizing return for investors by preventing it from selling property at the best time even if the company's and intentions have changed. Accordingly, NAREIT recommends that MA-REITs be permitted to develop for their own account 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 property held for at least two years. To the extent that there is concern about excessive property sales, NAREIT recommends that Malaysia consider rules similar to those used in the U.S. that would impose a 100% tax on gains from sales of properties that are held "primarily for sale in the ordinary course of business" of the REIT.

In response to Question 6, we assume that the proposed exclusion of "renovation, refurbishment or retrofitting" from the definition of "property development activities" is a means to prevent the properties associated with such activities from being limited to 15% of the MA-REIT's "enlarged total asset value in aggregate." As noted above, we do not believe that a limit on development properties is necessary.

In response to Question 7, NAREIT supports SC's proposal to increase an MA-REIT's minimum investments in real estate and/or single purpose companies to at least 75% of its total asset value at all times. This proposal would conform Malaysia's rules to those in the U.S. in order to ensure that MA-REITs have a substantial portion of their investments in income-generating real estate. In addition, NAREIT strongly urges that Malaysia consider allowing its REITs to invest indirectly through one or more levels of single-taxed entities.

Further, NAREIT recommends that Malaysia consider defining the types of real estate assets a REIT may invest in broadly. The U.S. experience may be instructive. Quarterly, at least 75% of a U.S. REIT's assets must consist of "real estate assets," Government securities, cash and cash items.[5] The term "real estate assets" is defined broadly to include interests in real property (fee ownership and co-ownership of land or improvements thereon, leaseholds of land or improvements thereon, options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon), as well as interests in mortgages on real property, shares of other REITs, and any property that is attributable to the temporary investment of new capital.[6] REITs may invest in U.S. properties or non-U.S. properties. U.S. tax law "looks through" all of the tiers of a REIT's ownership of single-taxed entities (like partnerships) to determine the real estate assets owned by the REIT. On the other hand, REITs cannot own more than 10% of the securities of any corporate entity other than another REIT, a taxable REIT subsidiary, or a "qualified REIT subsidiary" (a wholly owned subsidiary which is completely

[5] Section 856(c)(3) of the Internal Revenue Code of 1986 (the Code, and unless otherwise noted, any reference to a "section" shall be to a section of the Code).
[6] Sections 856(c)(5)(B) and (C).

disregarded for U.S. tax purposes, and the income and assets of which are viewed as owned by the REIT).

The broad definition of "real estate assets" allows for a great amount of flexibility, not just for the newly formed REIT as it looks for investment opportunities, but also for the existing REIT as it considers other types of real estate related investment opportunities. Flexibility has been important to U.S. REITs because it has allowed them to own new types of properties as market conditions change. For example, in 1994, office REITs comprised only 4% of the total U.S. REIT market while in 2004, office REITs comprised about 12% of the total U.S. REIT market. Similarly, retail REITs were 35% of the total REIT market in 1994, and as of July 29, 2016 they are approximately 24% of this market by equity market capitalization.

The broad definition of "real estate assets" also has allowed U.S. REITs to invest in all types of loans secured by real property. For example, in recent years, REITs have enhanced their debt portfolios by providing short-term mezzanine financing to borrowers secured by the borrower's ownership interest in the tax transparent entity that owns the relevant property. Mezzanine financing provides for a higher than average rate of return as well as fairly expedited default procedures in the event of default. A loan secured by a partnership or limited liability interest is treated as a "real estate asset" if most of the partnership or limited liability company's assets consists of real property equal to or in excess of the amount of the loan, and a number of related conditions are satisfied. Mezzanine financing can serve as the basis for a lender to acquire the property secured by the financing in case the borrower gets into financial difficulty.

B. Allow Market Discipline to Determine Appropriate Debt Levels

1. SC Proposals and Issues for Consultation

Under current law, MA-REITs are subjected to a leverage limit of 50% of their total asset value, which may be increased if the REITs obtain approval of their unit holders by way of an ordinary resolution. With the current flexibility, the SC seems to be concerned that there is a risk that a REIT may over-leverage in pursuit of rapid growth. To contain this risk and ensure sustainable growth, the SC proposes to adopt a fixed leverage limit of 50% without the option for REITs to increase this limit by obtaining approval of the unit holders.

Issue for Consultation (Proposal 6)

Question 17: Do you agree with the SC's proposal to adopt a fixed leverage limit of 50%? Please provide specific reasons for your views.

2. Allow Market Discipline to Determine Appropriate Debt Levels

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 and investors) 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 May 31, 2016, 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 33.4 %, their coverage ratio of EBITDA divided by interest expense was 4.1 and their fixed charge rate of EBITDA divided by interest expense plus preferred dividends was 3.7.[7]

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 May 31, 2016, 46 U.S. equity REITs, or 62% of the industry by market capitalization, had investment grade ratings.[8] 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 30-45% 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.[9]

NAREIT recommends that legislation provide the flexibility to meet different market challenges and not limit the level of gearing for an MA-REIT. If the Malaysian government believes that there must be some limitation on gearing, then NAREIT suggests that gearing be limited based on reference to a company'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.[10] Specifically, the U.K. provides that the interest cover 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. An interest coverage ratio test allows companies to achieve objective gearing ratios without worrying about short-term changes in stock prices such as those that were caused during the 2008 Great Financial Recession. Further, NAREIT recommends that an MA-REIT should have the ability to petition

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[7] *See* https://www.reit.com/sites/default/files/reitwatch/RW1606.pdf (page 2).
[8] *Id.*
[9] *See, e.g.,* http://www.dallasfed.org/assets/documents/research/swe/2002/swe0206c.pdf .
[10] *See* EPRA Global REIT Survey 2015 (U.K.) http://www.epra.com/regulation-and-reporting/taxation/epra-newsletter-nov200911.

the Malaysian government for an exception to any leverage limits to account for unforeseen market conditions.

C. Enhancement of Corporate Governance Standards

1. SC Issues for Consultation

Issue for Consultation (Proposal 7)
Question 18: Do you agree with the SC's proposal for the board of directors of a REIT manager to provide a Statement of Corporate Governance and a Statement of Internal Control in the annual report of a REIT? Please provide specific reasons for your views.

Issue for Consultation (Proposal 8)
Question 19: Do you agree with the SC's proposal to make it mandatory for REIT managers to establish an audit committee? Please provide specific reasons for your views.
Question 20: Do you agree that the requirements in the Bursa Listing Requirements in relation to audit committee be made applicable to REITs? Please provide specific reasons for your views.

Issue for Consultation (Proposal 9)
Question 21: Do you agree with the SC's proposal to introduce a requirement to allow the removal of the REIT manager by way of a resolution passed by a simple majority of unit holders voting at a general meeting? Please provide specific reasons for your views.
Question 22: Do you agree with the SC's proposal to allow a REIT manager and related parties of the REIT manager to vote and be counted in the quorum at the meeting to remove the REIT manager? Please provide specific reasons for your views.

Issue for Consultation (Proposal 10)
Question 23: Do you agree with the SC's proposal to require that on completion of the termination of a REIT, unit holders be provided with a REIT manager's report explaining how the real estate has been disposed of, the transaction price and salient terms of disposal? Please provide specific reasons for your views.
Question 24: Do you agree with the SC's proposal to require that on completion of the termination of the REIT, unit holders be provided with a trustee's report stating that the REIT manager has managed and terminated the REIT in accordance with the provisions of the REIT's deed? Please provide specific reasons for your views.
Question 25: Do you agree with the SC's proposal to require copies of the REITs financial statements to be distributed to unit holders and filed with the SC within two months of the completion of the termination of the REIT? Please provide specific reasons for your views.

Issue for Consultation (Proposal 11)
Question 26: Do you agree with the SC's proposal to require a revaluation of each of a REIT's real estate to be conducted at least once in each financial year? Please provide specific reasons for your views.

Question 27: Do you agree with the SC's proposal to allow a valuer to conduct valuations of any particular real estate of a REIT for up to three consecutive years only? Please provide specific reasons for your views.

2. NAREIT Supports the Enhancement of Corporate Governance Standards

In the U.S., the provisions of *The Sarbanes-Oxley Act of 2002*,[11] *The Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank)[12] and those of exchanges such as the New York Stock Exchange (NYSE)[13] 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.[14] 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.[15]

Accordingly, NAREIT generally supports intentions motivating the SC proposals set forth in the Paper to facilitate growth, as well as to foster strong governance culture in order to protect investors, maintain market integrity and promote long-term sustainability of Malaysia's REIT market**.** Moreover, many in the marketplace believe that there are fewer conflicts of interest when REITs are internally managed. Also, as further described below, in addition to the above changes, we believe that the most important step Malaysia could take to enhance corporate governance would be to allow for internally advised and managed REITs. Finally, NAREIT believes that the disclosure and governance standards applicable to MA-REITs should be similar to those applicable to non-MA REIT corporations or business trusts.

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[11] Available here: http://www.gpo.gov/fdsys/pkg/BILLS-107hr3763enr/pdf/BILLS-107hr3763enr.pdf
[12] Available here: http://www.gpo.gov/fdsys/pkg/CRPT-111hrpt517/pdf/CRPT-111hrpt517.pdf.
[13] *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.
[14] 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.
[15] *See, e.g.*, *Shenker v. Laureate Educ. Inc.*, 411 Md. 317, 351 (2009).

D. NAREIT Agrees with the SC Proposal to Allow for MA-REITs to Be Either Externally-Managed or Internally Managed

1. SC Proposal and Issue for Consultation

Following inquiries regarding whether MA-REITs may be internally managed, the SC will amend the REITs Guidelines to add further clarity that an internally managed REIT structure is allowed. Internally managed REITs may be in the form of a REIT owning the shares of the REIT manager or when the units of a REIT are stapled to shares of the REIT manager.

Issue for Consultation (Proposal 15)

Question 37: What are your views on internally managed REITs?

2. NAREIT Recommendations: Allow Choice of Internal or External Management

NAREIT believes that the stapled REIT structure is a work around to the general rule that does not accept internally advised/managed REITs. NAREIT applauds the SC for considering not just a stapled structure, but for also proposing to allow an MA-REIT to own the shares of the REIT manager. Instead of merely modifying the rules applicable to stapled REITs (as we understand that Singapore has done) and allowing ownership of the REIT manager, however, NAREIT encourages the SC to take the 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, and most European countries that have adopted REIT rules and modify the law in order to permit MA-REITs the option to be either externally or internally managed through their own employees.

There is sometimes confusion regarding the definition of **externally advised** vs. **externally managed.** An **externally-managed** REIT is <u>not only</u> 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.[16]

[16] 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. Generally, the self-advised designation indicates the company provides its own asset management services (investment acquisition/ disposition decisions) or the advisor is a subsidiary. 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 managers 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. NAREIT's recommendation is that the SC permit MA-REITs the option to be either **externally managed** or **internally managed**.

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.[17]

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/self-managed model over the past 30 years.

Some observers believe that there is a greater potential for conflicts of interest for an externally-managed REIT than for a self-managed REIT, especially when the REIT employees own the external advisor.[18]

For example, a Fitch Ratings analysis[19] of 18 externally managed U.S. REITs and 106 internally managed U.S. REITs found the following:

> [I]nternally managed REITs are not better at controlling administrative expenses versus externally managed companies, despite popular opinion to the contrary. Investors have frequently asked Fitch which management structure is preferential at managing overhead, namely general and administrative (G&A), expenses for REITs.
>
> …[T]he cost associated with managing an internal managed REIT versus an external managed REIT is 20 bps higher from a total market value perspective. However, Fitch believes that stock ownership, corporate governance, potential conflicts of interest, allocation of investment opportunities and management time are still the greatest risks of externally managed REITs. Ensuring alignment of interests between investors and management is the key aspect at enhancing investor trust and support for externally managed REITs. Most externally advised REITs fall short on at least one of these items.

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[17] 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.

[18] *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.ipf.org.uk/resourceLibrary/real-estate-investment-trusts--the-us-experience-and-lessons-for-the-uk--may-2009-.html (noting that "[t]oday a US REIT can choose whether to be internally or externally managed, and almost all have chosen the internal option.").

[19] Available at: https://www.fitchratings.com/gws/en/fitchwire/fitchwirearticle/Externally-Managed-REITs?pr_id=843695 *See also* "The Proof Is In The Pudding: Externally Managed REITs Underperform" by Brad Thomas (April 5, 2016), available at: http://seekingalpha.com/article/3963131-proof-pudding-externally-managed-reits-underperform (subscription required).

> Since 2010, G&A expenses were higher for internally managed REITs versus externally managed companies. For example, externally managed REITs' efficiency ratios, G&A expenses as a percentage of total revenues, were mostly between 4%-6% with a median ratio of 5.22%. By comparison, this ratio for internally managed REITs was between 5%-7% with a median ratio of 6.60%. Further, we did not find any significant differences in G&A expenses as a percentage of gross assets for internally and externally managed REITs.

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 or self-managed, the capital markets tend to prefer that listed U.S. REITs be self-advised. For example, as of December 31, 2015, about 84% of listed equity (property-owning, as opposed to mortgage-owning) U.S. REITs by equity market capitalization were self-advised, and about 78% were self-managed. Most non-traded U.S. REITs appear to be externally advised.

Self-advised REITs do not need outside advisers and self-managed REITs do not need outside managers, thereby obviating potential conflict of interest issues arising from external advisor/management structures. 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 MA-REITs to become self-advised/self-managed over time.

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Thank you for the opportunity to submit these comments. Please contact me at dbernstein@nareit.com or Tony M. Edwards, NAREIT's Executive Vice President & General Counsel, at tedwards@nareit.com, if you would like to discuss them in greater detail.

Respectfully submitted,

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