

Hong Kong – Applying Securities Laws to Sales of Hotel Units

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SFC treats the sale of individual units in a Hong Kong hotel as a collective investment scheme

In a move that represents a first in Hong Kong, one of the territory's largest listed property developers, Cheung Kong (Holdings) Limited and certain of its subsidiaries have entered into an agreement with the Securities and Futures Commission (SFC), the securities regulator, to unwind a sale of individual units in a Hong Kong hotel, known as The Apex Horizon, that took place earlier this year. This marks the end of a legal battle in which the SFC claimed that the sales of the hotel units amounted to a *collective investment scheme* (CIS), which requires the prior approval of the SFC. Cheung Kong, which is controlled by Li Ka Shing, one of Hong Kong's wealthiest businessmen, had insisted that the company was just selling an asset, which is not subject to those restrictions.

There are many novel and unique elements to the transaction that gave rise to this result. Aside from the fact that a sale of units in a hotel in Hong Kong was without precedent, there were two further features of this sale of hotel rooms that attracted government and media attention. First, the sale exploited a legal loophole that was closed in 2003, which had allowed hotels to be sold in parts. Cheung Kong had acquired the hotel site prior to 2003 and therefore was not subject to this restriction. Second, as the units were classified as commercial properties, the sales arguably were not subject to the recently announced increased property transfer taxes (known as *stamp duty*), which were intended to tackle property speculation. During the sale, all 360 rooms on offer were sold, but some buyers seeking to resell their units encountered problems when there was confusion about the nature of the interest they had acquired. Buyers of the units did not acquire exclusive possession and the classification of the hotel as a commercial property meant that the hotel rooms could not be used as residences.

After investigating the sale of the hotel units, the SFC formed the view that the offer made by the seller appeared to be an invitation to the public to acquire an interest in, or to participate in, a CIS, the marketing of which requires prior SFC approval, which was neither sought nor obtained.

A CIS is defined very broadly under Hong Kong's Securities and Futures Ordinance to include arrangements: (i) in respect of any property; (ii) under which the participating persons 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 about the management of the property; (iii) under which the property is managed as a whole by or on behalf of the person operating the arrangements; and (iv) the purpose or effect of the arrangement is to enable the participating persons to participate in or receive profits, income or other returns from the acquisition, holding or management of the property.

The SFC took the view that the key elements of a CIS that appeared to exist in the offer included the fact that day-to-day management of the hotel was to be in the hands of a separate operator appointed to operate the hotel on behalf of the buyers, and that the hotel operator would control key functions necessary to manage and supervise the hotel, including allocation of guests to rooms.

Although Cheung Kong did not agree with the SFC's view and claimed that the buyers had effective day-to-day control of their rooms and that they had made an investment in real estate, the agreement was entered into after the SFC had indicated that it intended to commence legal proceedings against Cheung Kong. The agreement to undo the sales required Cheung Kong to issue a letter to each buyer informing them that it wished to cancel its contract, and to reimburse them for the hotel unit purchased plus an additional amount to cover the purchaser's legal and other expenses.

Previously, an Asian-branded service apartments operator attempted the sale of individual strata title units in Hong Kong. In that case, potential buyers were given the option of having the operator continue to manage and lease their units in return for which a guaranteed return would be paid, or using it as their residence, in which case the buyer would receive no returns and would be responsible for the management fees. It is unclear whether this proposed sale ran into the same difficulties with the SFC as Cheung Kong's did, but it certainly failed to attract anywhere near the level of regulatory attention and publicity. In any event, it appears the plan did not go through due to commercial reasons.

CIS and sales of securities to the public in Hong Kong

Under Hong Kong's regime for the marketing of securities it is illegal to publish any document, invitation or document which contains an invitation to the public to acquire an interest in or participate in a CIS, unless the offering document has been authorized by the SFC for such issue. Any other marketing materials would be subject to this requirement as well.

The procedure for authorization requires that an application be submitted to the SFC, which would include the draft of the offering document. The process would include a review of the offering document and, depending on the product, its structural features, to see if certain benchmarks are met and the required information is disclosed. There are various SFC codes used for different types of retail investment products, and any applicant for authorization would need to apply under the correct code for its product.

The nature of the interests in the units acquired by buyers in The Apex Horizon was not clear. Given that it was not Cheung Kong's intent to establish a CIS, it appeared that it did not establish any formal CIS structure to comply with any of the SFC codes. In any event, none of the codes are designed to accommodate a CIS for hotel units. This raises the question as to whether this structure would be eligible for authorization at all, assuming that the rooms could be sold individually.

If the marketing of individual units in a development that is subject to an operating or management arrangement as described above were to constitute a CIS, this would have significant implications for the developer. It would mean that the developer must incur additional legal and other costs in pursuing the SFC authorization, and it would need to build into its marketing schedule a period of several months pending the processing and granting of that authorization before it could begin its marketing efforts. It also would mean, as is the case in The Apex Horizon situation, that if such a process was not complied with, but the sale proceeded regardless, the buyers of the units might be able to cause the sales to be rescinded at a later date.

Implications of The Apex Horizon decision and the U.S. experience

Although The Apex Horizon situation is novel, the position taken by the SFC could have a much broader application. The same analysis potentially could apply to any sales of real estate (whether strata-title or not) that are intended to be managed by third parties and leased on a transitory basis. This would cover sales of "condotels", a product that has been gaining more and more popularity in Asia over the past couple of years (although less so in Hong Kong). In that context, the U.S. experience could be highly relevant.

The application of U.S. securities laws to sales of real estate products can be traced to a U.S. Supreme Court case from 1946, *SEC v. W.J. Howey Co.*, which held that an interest will be considered a security (and thus subject to U.S. securities laws) in the event the investment includes: (i) an investment of money; (ii) a common enterprise; and (iii) an expectation of profits solely from the efforts of a third party managing the interest. Since the *Howey* case, the SEC has issued a number of no-action letters clarifying (and sometimes changing) its position. While the exact application of the analysis is always fact-specific, it is clear that in determining if a sale of real estate interests would be considered a sale of a security, the SEC and U.S. courts look at the following elements:

1. Whether or not the buyer of the real estate is restricted from using the property and/or is required to enter into a rental arrangement.
2. Whether or not the revenues from leasing the real estate are pooled with the revenues from leasing of the other properties (typically in the same building/complex) being managed by a third-party manager.

3. Whether the marketing and sales process is focused on the economic benefits of the third-party manager of the units.

The overall concept is that the more the real estate purchase is bundled with the decision to lease the property to a third-party manager, the more likely it is that the developer will be found to be marketing a security.

Needless to say, if the sale of real estate interests is deemed to be a sale of securities, any such sales would need to comply with the U.S. Securities Laws, including the registration requirements under Section 5 of the Securities and Exchange Act of 1933. Because the real estate interests are offered to the public at large, this would mean that the developer would need to put in the cost and time involved in doing an initial public offering (IPO) – not something any developer would want to do.

The Apex Horizon situation may be a one-of-a-kind event driven by specific circumstances (in particular, the view that it was being used to get around the new increased property transfer taxes), or it may be a sign of things to come. If the latter is true, and this approach is adopted in other Asian jurisdictions, developers and promoters will want to pay very close attention to local securities laws and how they should structure and market any for-sale real estate products that are being managed by a third party in order to avoid the same outcome. Condotels have gained popularity in Asia recently and some developments are being marketed with mandatory rental programs and guaranteed returns – the same components that the SEC in the U.S. and the SFC in Hong Kong have identified as indicating such sales would be deemed as sales of securities.

Monetizing real estate in Asia

Cheung Kong's actions in connection with The Apex Horizon should be viewed in a broader context recognizing the continued effort by Asian-based developers to find new and quicker ways to monetize their holdings in hospitality products. Cheung Kong itself originally had planned to spin off four hotels (including The Apex Horizon) through the route of a trust that would be listed on the Hong Kong Stock Exchange, but this plan was put on hold in December, 2012. This would have involved a very different structure and a much longer time frame for closing than the sale of individual units. Several other Hong Kong developers and property holding companies are in the process of spinning off hotels through a trust in fairly quick succession in this way. In Singapore, similar results have been accomplished via REITs, which have proved to be popular in that jurisdiction. Thus, we expect to see more and more new products and structures in this space as time goes by.

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