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Current & Proposed Amendments to the Real Estate Investment Company Regulations

March 23, 2023

The Real Estate and Alternative Investment Practice Group of SHIN & KIM LLC would like to introduce key amendments to the laws governing real estate investment companies ("REITs") in 2022, as well as those expected in 2023.

In this newsletter, we take a look at key amendments adopted in the Supervisory Regulation on Real Estate Investment Companies, etc. (Ministry of Land, Infrastructure and Transport Directive No. 1557, effective on September 13, 2022) and the Enforcement Decree of the Real Estate Investment Company Act (Presidential Decree No. 32639, effective on May 9, 2022). Further, we also touch on the expected amendments based on press release by the Ministry of Land, Infrastructure and Transport (the "**MOLIT**") on January 5, 2023 with regard to the measures to enhance REITs' competitiveness.

1. Amendments to the Supervisory Regulation on Real Estate Investment Companies, etc. – evaluation of management of asset management companies

On September 13, 2022, the Supervisory Regulation on Real Estate Investment Company (the "**Supervisory Regulation**") was amended in part. The purpose of such amendment is to provide for specifics necessary to implement the sound management standards and management evaluation system concerning asset management companies, which were newly introduced by the amended Real Estate Investment Company Act (the "**REIT Act**") (promulgated on December 22, 2020 and enacted on June 23, 2021) and the amended Enforcement Decree of the REIT Act (promulgated and enacted on June 23, 2021). The amendment of the Supervisory Regulation also seeks to improve or supplement certain shortcomings identified under the current regime of the REIT Act.

The amended Supervisory Regulation has been in effect since September 13, 2022, and the details of the amendments are as follows:

1) Article 9-2: Establishment of standards to be followed by asset management companies to maintain management integrity such as capital adequacy ratio, risk management and internal compliance.
2) Article 9-3: Establishment of quantitative and qualitative criteria to evaluate the management of asset management companies, 5 ratings and exemptions from this management evaluation.
3) Article 9-4: Issuance of an agency recommendation to the companies that received a low evaluation rating to improve their management.
4) Article 9-5: Imposition of an obligation on the companies that received an agency recommendation to submit a management improvement plan and issuance of a corrective order in case the management improvement plan is not approved.
5) Article 11: Extension of the submission deadline for a business report from 45 days to 90 days of each fiscal year end.

2. Amendments to the Enforcement Decree of the REIT Act (enacted on May 9, 2022)

A. Relaxed computation of real estate assets of the REITs (Article 27(3))

A REIT must invest at least 70% of its total assets in real estate assets including buildings under construction, and failure to do so may result in revocation of its business license. However, under the former Enforcement Decree of the REIT Act, security deposits received by the REIT for leased residences and deposited with a financial institution are (while included in its total assets) not considered real estate assets. Thus, in cases where a substantial portion of the REIT's assets consists of rental housing or there is a temporary upsurge in the security deposits, the REIT would not be able to maintain the real estate asset ratio required under the law.

To address such issue, the amended Enforcement Decree of the REIT Act carved out security deposits received by the REIT for leased residences and deposited with a financial institution from its total assets, thereby relaxing the burden the former law had imposed on the REIT's operation of rental housing assets.

Article 27(3) of the Amended Enforcement Decree of the REIT Act

Article 27 (Selection Criteria of Assets) (3) The value of assets under Article 25(1) of the Act shall be calculated in accordance with the following:

3. For deposits in financial institutions: sum of the principal (excluding security deposits received for the leasing of private rental housing under the "Special Act on Private Rental Housing" and public rental housing under the "Special Act on Public Housing") and interest accrued by the calculation date.

B. Additional exceptions for asset management company's business license revocation (addition of new Subparagraph 2 to Article 43-2(1))

An asset management company whose equity capital falls below KRW 7 billion may have its business license revoked. The issue was that an asset management company that was unable to meet such requirement due to its business being in its early stage or temporary underperformance was also at risk of having its license revoked as the former Enforcement Decree of the REIT Act did not take such circumstances into account.

The amendment now allows more flexibility for the asset management companies to continue their business. Under the amendment, even if an asset management company fails to maintain the minimum equity capital, its business license will not be revoked if (i) two fiscal years (including the fiscal year in which the business license was issued) have not elapsed since the issue date of its business license; or (ii) the duration of such failure is limited to a single fiscal year.

Article 43-2(1)2 of the amended Enforcement Decree of the REIT Act

Article 43-2 (Revocation of Business License, etc.) (1) In the proviso to Article 42(1)4 of the Act, "cases prescribed by the Presidential Decree, such as temporary failure to meet the requirements for business license, registration or incorporation authorization," refer to each of the following:

2. Where the asset management company fails to meet the equity capital requirement under Article 22-3(1)1 of the Act and falls under any of the following cases. Determination of whether or not the equity capital requirement is met shall be made as of each fiscal year end.
   A. Where two fiscal years have not elapsed from the date on which its business license was issued under Article 22-3(1) (including the fiscal year in which the license was issued); and
   B. Where the fiscal years (excluding the fiscal year falling under item A above) during which the failure to meet the equity capital requirement are not consecutive.

The above amendment has been in effect since May 9, 2022.

3. Proposed amendments to the REIT Act on July 26, 2022

A. Exclusion of listed parent-sub REITs from the application of the holding company regulations under the MRFTA Act (addition of new Paragraphs (5) and (6) to Article 49) (*pending*)

Listed REITs seeking to increase its liquidity and stability by adding multiple real properties into its investment portfolio may utilize a parent-subsidiaries structure with one subsidiary holding one investment asset (the "**parent-sub REIT**"), which allows separate recognition of profit and loss from each investment asset thereby safeguarding a certain investment asset from the risks of the others. However, under the current REIT Act, the parent REIT can be subject to the heavy regulations

applicable to holding companies under the Monopoly Regulation and Fair Trade Act (the "**MRFTA**") in the event it qualifies as a holding company by establishing multiple subsidiaries. Thus, there is a concern that REITs seeking to grow their investment portfolio may be discouraged from taking advantage of the parent-sub REIT structure.

To address such issue, a new amendment of the REIT Act has been proposed to carve out an exemption for listed REITs that meet certain requirements from the application of holding company regulations under the MRFTA.

Article 49(5) and (6) of the REIT Act

Article 49 (Relationship with Other Statutes) (5) Provisions applicable to a holding company under the Monopoly Regulation and Fair Trade Act shall not apply to a real estate investment company (limited to third party managed real estate investment company or corporate-restructuring real estate investment company) that meets the requirements under each following subparagraph:

1. It has listed its shares on the securities market in accordance with Article 20;
2. It has become a holding company by acquiring shares of other real estate investment companies (limited to those that do not own shares of another company) in order to invest in and manage real estate assets within the scope of business under Article 4;
3. It is a company that does not belong to a company group subject to public disclosure pursuant to the former part of Article 31(1) of the Monopoly Regulation and Fair Trade Act; and
4. It does not own any shares other than the shares of the real estate investment companies acquired under subparagraph 2.

(6) If a REIT falls under Paragraph 5, the asset management company entrusted with the investment and management of assets by the REIT shall report such fact to the Minister of Land, Infrastructure and Transport within two weeks from the date on which the requirements are met, in accordance with the method prescribed by the Presidential Decree, and the Minister of Land, Infrastructure and Transport must notify the same to the Fair Trade Commission.

The MOLIT is of the view that the holding company regulations under the MRFTA do not need to be applied to the REITs considering that the business license for REITs is issued only after the MOLIT and the Korea Real Estate Agency sign off on their stability and adequacy of their investment targets based on their review of the REITs' business plan and verification of asset valuation. The Fair Trade Commission is also in favor of the proposed amendment.

B. Simplified consultation procedure with the Financial Services Commission for public placement REITs. (Amendment to Article 49-3(2) of the REIT Act) (*pending*)

Under the current REIT Act, the Minister of Land, Infrastructure and Transport must consult with the Financial Services Commission prior to the issuance of business license and registration of a public placement REIT.

Under the current regime, consultation with the Financial Services Commission concerning public

placement REIT must be carried out twice: first, the business license (registration) authorization phase; and second, during the review of a securities registration statement prior to the public offering and listing of a REIT. However, as the review processes are substantially similar (i.e., involving review of the same documents and issues), in practice, substantial consultation with the Financial Services Commission is usually carried out during the review of a securities registration statement while the first consultation at the business license (registration) authorization phase under Article 49-(2) of the REIT Act is carried out merely as a formality.

To address such redundancy, a new amendment has been proposed to omit the consultation process with the Financial Services Commission at the business license (registration) authorization phase.

Article 49-3(2) of the REIT Act

Article 49-3 (Special Measures for Public Placement Real Estate Investment Company)
(2) Where the Minister of Land, Infrastructure and Transport grants ~~(i) a business license / registration for a public placement real estate investment company or (ii)~~ an authorization to an asset management company under Article 22-3 (excluding an asset management company entrusted with investment and management of assets exclusively by private placement real estate investment companies), he or she shall consult with the Financial Services Commission in advance.

The MOLIT is in favor of the proposed amendment in the interest of administrative efficiency, as well as the Financial Services Commission and the Financial Supervisory Service who share such view.

The proposed amendment to the REIT Act was submitted to the Land, Infrastructure and Transport Committee of the National Assembly on July 27, 2022, and the Committee completed its review on September 23, 2022.

4. Proposed amendments to the REIT Act on September 1, 2022 – Grant of dividends through a resolution of the board of directors (to shorten the dividend cycle) (*pending*)

Investors invest in listed REITs generally for dividend income rather than for capital gains. In particular, there has been an increase in investments in REITs with relatively high dividend yields due to the increase in the population of elderly people who want to secure stable income. However, the current REIT Act does not include provisions that allow shortening of the dividend cycle, and as such, it does not afford to meet investors' demands for monthly or quarterly dividends.

Accordingly, amendments to the REIT Act were proposed to make it possible to shorten the dividend cycle of REITs by a resolution of the board of directors and to pay dividends on a monthly (quarterly) basis. These amendments are aimed at redirecting the investment demands of the investors who

want monthly (quarterly) dividends from overseas REITs to domestic REITs and stabilizing the income sources for those investing in income producing financial products such as the elderly and pensioners (amendment to Article 28(3), and addition of new Paragraphs 6 to Paragraph 8 of Article 28).

Article 28(3), (6), (7) and (8) of the REIT Act

Article 28 (Dividends) (3) Where a third party managed real estate investment company pays dividends in accordance with Paragraph (1) and Paragraph (6), it may do so in excess of its profits, notwithstanding Article 462(1) of the Commercial Code. In such case, the base of excess dividends shall be as set by a Presidential Decree to the extent not exceeding the depreciation cost for the relevant year.

(6) Notwithstanding Article 462-3 of the Commercial Act, if all of the following requirements are met, a real estate investment company may pay dividends subject to a resolution of its board of directors which determines the number and cycle of dividends and the expected amount of dividends (the "**Interim Dividend**" in this Article):

1. The net assets of the company on its pro-forma balance sheet for the relevant period shall exceed the sum of the following amounts:
   A. Amount of estimated capital for the relevant period
   B. Sum of estimated capital reserve and estimated earned surplus reserve for the relevant period
   C. Amount of earned surplus reserve to be set aside for the relevant period
   D. Amount of estimated unrealized profits as prescribed by the Presidential Decree
2. All statutory auditors (supervisory directors in the case of a real estate investment company without statutory auditors) must agree
3. The articles of incorporation shall provide that dividends can be paid by a resolution of its board of directors during the relevant period

(7) A real estate investment company shall not pay Interim Dividends if there is a possibility that the amount of its net assets on the balance sheet for the relevant period is less than the sum of the amounts set forth in each subparagraph of Article 462(1) of the Commercial Code.

(8) Directors who consent to the resolution of the board of directors approving Interim Dividends when the amount of its net assets on the balance sheet for the relevant period is less than the sum of the amounts set forth in each subparagraph of Article 462(1) of the Commercial Code shall be jointly liable with the real estate investment company to compensate for the difference unless they can prove that they could not have known of the possibility described in Paragraph 7 despite having taken due care.

The above proposal was submitted to the Land, Infrastructure and Transport Committee of the National Assembly on September 2, 2022, but has not been introduced yet.

5. Major changes introduced in the MOLIT's press release dated January 5, 2023 (Measures to strengthen REITs' competitiveness)

A. Allowing issuance of commercial papers (CP) to raise funds for REITs (*pending*)

Currently, REITs may raise debt financing only by obtaining loans and issuing bonds; as such, there are limitations on the REIT's ability to secure short-term financing and to respond to the market conditions in a flexible manner. The MOLIT announced plans to allow REITs to issue commercial papers (CP) such that REITs can enjoy more flexibility in raising debt financing that it is needed.

To issue commercial papers, it is necessary to obtain credit ratings of B or higher from two or more credit rating agencies; as such, the issuance of commercial papers by REITs is not likely to pose issues with investor protection. However, the MOLIT stated that they would regulate the issuance of commercial papers to prevent indiscriminate issuance by requiring REITs to consult with the MOLIT in advance of issuance.

B. Relaxation on the requirements for recognition of investments in real estate companies as REITs' real estate assets (50% → 20%) (*pending*)

As stated above, REITs must invest at least 70% of its total assets in real estate assets and failure to do so may result in revocation of their business license. "Real estate assets" include investments in, among others, (i) companies or associations with at least 80% of their total assets invested in real estate assets ("**Real Estate Companies**"), (ii) other REITs or real estate collective investment vehicles and (iii) real estate development projects. However, in the case of investments in the Real Estate Company, the amount invested by the REIT to acquire equity securities issued by the Real Estate Company is recognized as "real estate assets" only when the REIT acquires more than 50% of the total number of the Real Estate Company's equity securities.

Considering that the above limitation may hinder the expansion of the REITs' investment portfolio, the MOLIT announced a proposal to reduce the threshold to 20% so that the amount invested by the REIT to acquire 20% or more of the total number of equity securities in a Real Estate Company can be recognized as its "real estate assets".

For Questions or Comments

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