

## Ad Interim Report on Discussion Results by the Working Group

### 1. Introduction

Since commencement in 2001, the Japanese market of listed real estate investment trusts (J-REITs) had grown steadily in terms of market size, number of acquired properties and number of listed issues. J-REITs had also made significant contributions to urban development and other aspects in Japan through acquiring properties with abundant funds as well as increasing the value of owned properties. However, triggered by the subprime loan problems that occurred last year, the entire J-REIT market turned to a downward trend. With the number of properties acquired by J-REITs quickly decreasing, the J-REIT system has entered an adjustment phase for the first time in the seven years since commencement. Even presently, the Tokyo Stock Exchange REIT Index remains low at the 800-point level due to the appreciation of the Japanese yen, globally decreased stock prices, worsening economic indicators and other factors. Thus, we believe it a pressing task to enhance investor confidence in J-REITs.

The Working Group has been discussing reorganization of J-REITs through mergers and other measures, the necessity of reinforcing the governance of J-REITs and other issues, in line with the directives demonstrated at the Third Forum for Building Up the Real Estate Investment Market that is Trusted by Investors held on November 29, 2008. The Working Group hereby presents an ad interim report on its discussion results.

### 2. Necessity of Reorganizing J-REITs through Mergers and Other Measures

It has been pointed out that the entire J-REIT market is being damaged by the fact that there are few mergers and acquisitions, although many investment corporations have a low price-to-book ratio (ratio of investment unit price to net assets per unit). Furthermore, there is a strong voice claiming that it is more desirable for pension funds and other investors to invest in stable REITs with larger total assets. A merger between investment corporations is a measure that would allow the creation of a larger size investment corporation without spending a lot of money. This would also help meet the expectations of investors and further activate the J-REIT market.

The Working Group held discussions, as described below, concerning mergers and other forms of reorganization of investment corporations. Given that the relevant systems are being revised in a way that should contribute to promoting mergers, the Working Group expects the J-REIT market to make further developments through mergers between investment corporations and other measures using these systems.

- (1) The present formula used to determine whether conduit requirements are satisfied includes both income for taxation purposes and profits for accounting purposes in a mixed way. In order to resolve the unstable nature of the conduit determination, revisions have been sought so that the judgment should be based on profits for accounting purposes, not including income for taxation purposes. There has also been a concern that investment corporations might hesitate to merge with other investment corporations because the present conduit requirements could not necessarily be satisfied after the merger. We believe this concern has been appeased, as the tax reform outline by the ruling parties decided at the end of last year clearly stated that the formula used to judge the conduit nature would be revised. The revisions included that a conduit shall distribute at least 90% of the distributable income (not the income for taxation purposes) for accounting purposes and that the negative goodwill generated upon a merger shall be deducted from the distributable income for accounting purposes in the fiscal year when the merger takes place. Moreover, the revisions to the formula allow the surviving investment corporation to deduct the unrealized gains of the absorbed investment corporation (so-called “negative goodwill”), if any, from the distributable income in the fiscal year when the unrealized gains occur. We believe that this has also eased the concern that, when conducting mergers, investment corporations must pay cash dividends equivalent to the unrealized gains in order to keep satisfying the conduit requirements.
  
- (2) In the case of a merger between investment corporations, the surviving investment corporation is required to pay the so-called merger grants to the unitholders of the dissolved investment corporation in order to adjust the fractions of the merger ratio or to adjust dividend of profits when the settlement periods of the merging parties differ. However, there were doubts concerning the practical application of this rule because there is no explicit provision in the Investment Trusts and Investment Corporations Law, and the concern was that this might discourage mergers between investment corporations. We believe this concern was eased as the Financial Services Agency revised the relevant Cabinet Office Ordinances (enforced on January 23, 2009) and its Inspection Guidelines (applied on January 30, 2009) in an effort to clarify the legitimacy of practical application.

- (3) When conducting an M&A, there may be fractions of investment units (less than one unit per unitholder) to be issued to the unitholders of the dissolved investment corporation. If that is the case, the Investment Trusts and Investment Corporations Law requires that the number of investment units equivalent to the sum of the fractions be sold at the stock exchange market and the proceeds from the sale be paid to the unitholders according to the fractions. This raised a concern that the investment unit price might drop significantly on the stock exchange market due to the sale. However, there were many in the Working Group pointing out that such a result could be avoided by, for example, trading on the ToSTNeT (Tokyo Stock Exchange Trading Network System) market.
- (4) As to the calculation method for a fair merger ratio upon merging, many members of the Working Group insisted that it is important to provide investors with sufficient explanation concerning the thinking behind the calculation, etc.
- (5) The Working Group also discussed delisting and liquidation of J-REITs as a form of reorganization. Both ways are legally possible, but there are such issues of concern as how opposing unitholders should be protected, the contraction of the J-REIT market due to sales of investment properties, and the impact of their fire sale, etc. on the overall real estate market. Accordingly, many members claimed that investment corporations should endeavor to stay in the J-REIT market through such measures as mergers, changes in sponsors and switch of asset management companies.

### 3. Corporate Governance of J-REITs

Recently, administrative penalties were imposed on multiple asset managers, to which investment corporations entrust management of their assets, for activities that constituted conflicts of interest with the investment corporations or for their inadequate internal control systems. Given these incidents, it has been pointed out that corporate governance of asset managers should be reinforced partly as a means of strengthening the trust of investors. Against this background, the Working Group held the below outlined discussions while making comparisons to systems of various countries.

- (1) The world's REIT systems are largely divided into externally-managed REITs (Japan, Australia and Singapore) and internally-managed REITs or a combination of externally- and internally-managed types (such as the U.S. and European countries.) Both the

externally-managed and the internally-managed types have their respective advantages, and no general valuation can be made concerning which is more beneficial for investors. However, as exemplified by the stapled securities system in Australia, there have been attempts to align interests of asset managers and investors by listing the shares of asset managers and investment units of the managed REITs together for trading while basically maintaining the externally-managed system to avoid taxation on the REITs before distributing dividends. As such, we believe there is a common global endeavor to enhance the trust of investors by aligning the interests of asset managers and investors as much as possible.

- (2) In the J-REIT system, the Investment Trusts and Investment Corporation Law and the Financial Instruments and Exchange Law allow asset managers to provide asset management services with the fiduciary duty and care of a good custodian on behalf of the investment corporations. Along with these duties, it is important for asset managers to make efforts to further align their interests with the interests of investment corporations, which are an assembly of investors, so as to enhance the trust of investors. In this regard, such schemes as internally-managed REITs and stapled securities system implemented in other countries can be informative. However, if we are to attempt to introduce similar systems in Japan, there are still many issues that need to be examined. As far as the internally-managed REIT, for example, an investment corporation would have to be a format that is more similar to a corporation under the Company Law as it manages assets by itself and, also from the perspective of a comparison with other legal systems, it would not be able to avoid taxation before paying dividends. With regard to the stapled securities system, there also appear to be many issues to be examined, as Japan has had no cases of trading shares of multiple companies as a single unit and there would be a need to discern how the system would be positioned in relation to the Financial Instruments and Exchange Law as well as other relevant laws and regulations. Many members of the Working Group insisted that, while it is important to continue examination among related parties on such ideas as internally-managed REITs and the stapled securities system in pursuing the ideal J-REIT system that secures the trust of investors, it is essential for each REIT to voluntarily work on measures that should further enhance the trust of investors. That would be a quicker way to reinforce investors' trust as soon as possible. Such efforts would include the following measures.

- (a) Strengthen monitoring by investment corporations on the fiduciary duties and other responsibilities being performed by their asset managers

Executive directors of investment corporations have an important mission to monitor, as representatives of investors, whether the asset managers that manage assets based on entrustment agreements with investment corporations are fulfilling their fiduciary duties, duties of diligence of a good custodian and other duties towards the investment corporations.

Investment corporations would need to secure personnel and budgets (such as increasing the number of directors and outsourcing some of the monitoring functions as needed) that are required to monitor how their asset managers are doing their fiduciary duties, duties of diligence of a good custodian and other duties, so as to allow the executive directors of the investment corporations sufficiently and proactively achieve their missions.

(b) Appoint outside directors for asset managers

From the viewpoint of reinforcing corporate governance of asset managers and enhancing the trust of investors, asset managers would appoint outside directors who are highly independent and can be expected to monitor the asset managers' business executions with a perspective of securing the interests of investors.

(c) Further elaborate the compensation systems of asset managers

Further elaboration would be made to the compensation systems of asset managers in a way that should contribute to the alignment of interests between asset managers and investment corporations.

Furthermore, in an attempt to align the interests between asset managers and investment corporations, investment corporations would own shares of asset managers in order to be able to have a certain influence on the asset managers. However, this would require prudent examination from the viewpoint of protecting investors, etc. as it would also cause investment corporations to bear the business risks of asset managers.

#### 4. Financing by J-REITs

With regard to equity financing by J-REITs, there were arguments made in the Working Group that, given the difficulty in increasing capital through ordinary public offerings in the present market where the investment unit prices stay low, capital policies of investment corporations would have to be more diversified – including the purchase of treasury stocks (their own investment units) and issuance of convertible bonds (investment corporation bonds

with subscription rights to new investment units) and preferred stocks (preferred investment securities), etc. – in order to reinforce their financial conditions via their own initiatives. The Working Group decided to continue discussing this subject, giving consideration to the viewpoint of investor protection.

As for debt financing by J-REITs, they have come to face difficulty in procuring debt funds under the impact of the turmoil in the global financial markets. Due to this, the Ministry of Land, Infrastructure, Transport and Tourism announced the “Emergency Measures for Activating the Housing and Real Estate Markets” at the end of last year. The measures will help financing by residence/real estate operators and others (including J-REITs) that conduct sound operations, through utilizing the operations of smoothly responding to crises by the Japan Finance Corporation. However, the Working Group decided to continue discussions on ideal debt financing by J-REITs. This is partly because redemptions of investment corporation bonds issued in the past will start in September 2009.

#### 5. Other Issues for Activating the Real Estate Investment Market

The Working Group plans to also discuss other issues for activating the real estate investment market, including information disclosure by J-REITs, appraisals and expansion of the investor bases into pension funds and retail investors.

(Reference 1)

Forum for Building Up the Real Estate Investment Market  
that is Trusted by Investors:  
List of Members of the Working Group

As of January 30, 2009  
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