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The Securities and Exchange Board of India's Draft Regulations on Real Estate Investment Trusts

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The Securities and Exchange Board of India (“SEBI”) finally released the draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013 (“Draft REIT Regulations”) on October 10, 2013. The Draft REIT Regulations were open for public comment until October 31, 2013, and SEBI should be formally introducing the regime soon.

The Draft REIT Regulations are the third initiative by the securities regulator to bring about a REIT regime in India, after a failed attempt to bring in REITs in 2008 (see report by Mansi Seth and Nishchal Joshipura, of Nishith Desai Associates, Mumbai, at *WSLR*, January 2008, page 10) and a subsequent initiative to bring in a REIT regime in the form of real estate mutual funds (“REMFs”), which also did not find any takers.¹ SEBI has finally sought to encourage investments in real estate as an asset class, and, in doing so, the regulator has clearly done a commendable job taking into account international models and the views of stakeholders.

REITs should likely emerge as a preferred form of asset backed investment with established revenue streams, and will go a long way in protecting the interests of investors seeking exposure in real estate as an asset class. More importantly, REITs may infuse addi-

tional transparency and liquidity into the Indian real estate market. With Indian players showing an increased keenness to list Indian real asset listings offshore, especially on the Singapore Exchange, SEBI's move is likely to attract such markets onshore and increase the depth of Indian real estate capital markets.

From a private equity in real estate perspective, REITs will also create exit opportunities for developers and financial investors, allowing them to move completed assets to REITs and provide much needed liquidity in the market.

Although the Draft REIT Regulations indicate a positive step forward on the part of SEBI, several issues concerning taxation, stamp duty and foreign participation remain.

In this Special Report, we analyze some of the most important provisions of the REIT regime and what additional steps need to be taken to ensure efficacious utilization of the REIT regime in India.

Investment Restrictions

The Draft REIT Regulations have taken cognizance of global standards on REIT regimes, and accordingly SEBI appears to have generally followed the 90 percent

rule on investment and distribution. This means that REITs are required to mandatorily invest in such a manner that:

- 90 percent of the value of the assets of the REIT are invested in “completed” (defined to mean properties which have received occupancy certificates) and “rent generating properties” (defined to mean properties not less than 75 percent of whose area has been rented/leased out);
- the remaining 10 percent may be invested in developmental properties, listed/unlisted debt of companies, mortgage backed securities, government securities and money market instruments/cash equivalents, among others;² and
- developmental properties have been defined to mean properties that are under construction (*i.e.*, for which an occupancy certificate has not been received). For investment in such developmental properties, REITs investment must be locked in for a minimum period of three years after completion.

Suggestions

- **Investing in limited liability partnerships (“LLPs”):** REITs can invest through special purpose vehicles (“SPVs”), which are defined to mean only bodies corporate as defined under the Companies Act, 2013. That definition defines a body corporate to include companies incorporated in India and outside India. LLPs are classified as bodies corporate under the Limited Liability Partnership Act, 2008, and therefore should qualify as SPVs under the Draft REIT Regulations. However, restrictions on investment activities of REITs would come under Regulation 18(1), which states that REITs are allowed to invest only in securities or properties in India. The definition of securities (as per Section 2(h) of the Securities Contracts (Regulation) Act, 1956 (“SCRA”)) does not include a partnership interest. Therefore, Regulation 18(1) will have to be modified to the extent of allowing REITs to also make investments in partnership interests.
- **Instruments in which REITs can invest:** A supplementary issue to the modification suggested in relation to LLPs and Regulation 18(1) is the restriction on REITs to investment only in securities and properties in India. Typically, all undefined terms draw their reference from the SCRA, which defines securities to mean marketable securities. Since a REIT will be investing mostly in private companies, the shares of such companies may not qualify as “securities” as defined under the SCRA.
- **The 75 percent rental limit:** The requirement to have at least 75 percent of the area to be leased out at all times appears currently to be seen on a continuous basis. This should be revised to be seen at the time of the valuation, and there should be a 12 month correction period to allow for some headroom in operations, as against the current six month (valuation update) period. Internationally, the focus is more on

completed assets and not as much on the extent of rentals, which is driven by markets.

- **Developmental property:** Investment in developmental property is only allowed to a maximum of 10 percent of the value of the assets of the REIT. This 10 percent flexibility was provided to allow a REIT to capitalize on capital appreciation benefits that come with investment in assets under construction. While the three year lock-in following completion is understandable to prevent speculative trading in land, the requirement to lease it out may be done away with. Further, such developmental assets should, at the option of the manager, be considered in the 90 percent bucket from the time they are completed and become rent generating.

Listing and Other Ancillary Issues

The Draft REIT Regulations mandate listing of the units of the REIT within 15 days of the closure of the initial offer. The initial offer requires filing the draft letter of offer with SEBI at least 30 days prior to filing the final letter of offer, and then making available publicly the letter of offer for public comments for 10 days, and then providing a five day notice after the filing of the final letter of offer before issuing such units to the public.

Some material requirements of note are as follows:

- A REIT must hold (and not merely propose to hold) real estate assets worth INR 1,000 crore (approximately U.S.\$160 million) prior to making the initial offer;³
- A REIT can offer its units to the public only by way of an initial public offer or a follow-on offer;⁴
- Trading of units of a REIT is permitted only on the floor;⁵
- The minimum public float shall be 25 percent,⁶ and any initial offer of its units to the public shall be for the value of units not less than 25 percent of the value of the REIT; and
- SEBI has prescribed the minimum ticket size of a REIT unit at INR 100,000 (approximately U.S.\$1,600) and further by requiring each applicant to purchase at least two units (*i.e.*, a minimum investment of INR 200,000 (approximately U.S.\$3,200)).

Suggestions

- **Listing proceeds:** The value of REIT assets should be INR 1,000 crore (approximately U.S.\$160 million) not prior to the offer, but at the time of listing. This will help the REIT to acquire real estate assets from the proceeds of the offer. A requirement to have identified property tied in by way of definitive documents and limitation on utilization of the offering monies may be provided for.
- **Preferential allotment/rights issue:** There is no provision for a rights issue or preferential allotment. This may be added, especially as the sponsor will be diluted if the units are only offered to the public.

- **Off market deals:** The trading of REIT units may also be permitted off the market by way of negotiated deals, just as in the case of listed shares. This will allow for greater investor participation.
- **Failure to maintain minimum public float:** Currently, failure to maintain a minimum public shareholding mandates a trustee to apply for delisting of the REIT. There should ideally be a cure period provided within which the sponsor could divest its shareholding to bring up the minimum public shareholding.

Valuations, Transparency and Disclosures

SEBI has prescribed extensive valuation, transparency and disclosure requirements for REITs in the Draft REIT Regulations:

- net asset value (“NAV”) to be calculated on a biannual basis;
- full valuation required once a year, including a physical inspection of the real estate site, followed by an update on any developments every six months; specific valuation requirements for the occurrence of any material events;
- purchase or sale of a property to require full valuation by two independent valuers, the average of whose valuation shall be the determined price for purchase/sale;
- event based disclosures will also be required to be made to the stock exchange and unit holders; and
- valuation undertaken by any valuer shall abide by international valuation standards and valuation standards as may be prescribed by the Institute of Chartered Accountants of India (ICAI) for the valuation of real estate, provided that, in case of any conflict, standards prescribed by the ICAI shall prevail.

Observations/Suggestions

- **No over-arching valuation requirements:** Extensive valuation requirements have been notified, including the requirement to carry out a full valuation of the assets of a REIT by the principal valuer to the REIT.⁷ SEBI has taken a practical steps towards valuation (unlike in previous regimes, such as the REMF product), requiring that the REIT conduct a full valuation once in a year, with physical site visits and a six month update valuation.⁸
- **ICAI norms for real estate valuation:** Requiring the valuation of REITs to conform with both international valuation standards and valuation standards prescribed by the ICAI, and valuation standards prescribed by the ICAI to prevail in case of conflict, may pose some challenges. This is because real estate has its own peculiarities, and the ICAI’s ability to value real estate remains to be seen. SEBI’s preference for the ICAI may have been based on an accountability perspective, since an Indian regulator would provide comfort to SEBI regarding valuations carried out. It might be helpful to suggest international valuation

standards to prevail in case of a conflict with ICAI prescribed standards.

- **Encumbrances on real estate assets — disclosures versus prohibition:** A key improvement (and another significant departure from the REMF/2008 REIT regime) is the manner in which encumbrance on titles has been perceived. It is common knowledge that legal proceedings against any real estate asset can be instituted which may not significantly affect the ownership or marketability of the real estate asset. Accordingly, SEBI has allowed for such properties to be acquired by the REIT, provided that adequate disclosures are made considering the sophisticated nature of the investors. In contrast, the REMF regime expected investee real estate assets to be “free of all encumbrances and not be a subject matter of any litigation.”⁹ This resulted in severe restrictions on investment in real estate, especially when many large projects were the subjects of fraudulent and *mala fide* litigation. The current draft of the REIT Regulations appears to have addressed this satisfactorily, only requiring the trustee to a REIT to ensure that the real assets held by it have a proper legal and marketable title and for adequate disclosure of any material litigation to be disclosed in the valuation reports to investors of the REIT. This will allow REITs to make investments in real estate properties previously inaccessible to investment vehicles.

Leverage

In general, SEBI is uncomfortable with leverage in investment vehicles. However, considering that globally REITs have significant leverage, SEBI has allowed leverage (on a consolidated basis) to a maximum of 50 percent of the value of its assets. In this regard, the REIT can avail leverage up to 25 percent without requiring any additional approvals. Beyond 25 percent, a credit rating and approval of 75 percent of the unit holders of the REIT (by value and number) is required to avail any further leverage.

Sponsor and Manager Obligations

Sponsors Held Accountable

SEBI has also sought to ensure that accountability is clearly levied on managers seeking to set up REITs. Following is a brief summary of the obligations imposed on sponsors:

- A “sponsor” to the REIT must hold at least 15 percent of the value of the REIT assets at all times.¹⁰
- Additionally, in order to ensure adequate “skin-in-the-game,” sponsors will be required to hold at least 25 percent of the value of the REIT assets for three years from the date of listing of the units of the REIT.¹¹
- Further, if the REIT holds any assets over and above the 25 percent limit outlined above, that holding will be locked in for a period of one year from the date of listing as well.¹²

- If a sponsor looks to move out of the REIT (*i.e.*, sell its mandatory 15 percent holding in a REIT), it will have to first obtain approval from 60 percent of the unit holders (in value and numbers) and require that the redesignated sponsor also agree to hold the minimum 15 percent.

Eligibility Criteria for REIT Managers

A recent feature in SEBI issued regulations has been the requirement for both manager entities and employees of such managers to be adequately qualified. In the Draft REIT Regulations, SEBI has set out the following as eligibility criteria:

- for the REIT manager: minimum net worth criteria (for INR 5 crore (approximately U.S.\$800,000)), and experience (of at least five years) in property management/fund management/advisory services or experience in real estate development; and
- for employees of REIT managers: in addition to the manager level experience, employees of the manager are also required to have at least two key personnel who have at least five years' experience in property management/fund management/advisory services or experience in real estate development.

Suggestion

- **Manager experience should be waived initially:** It is likely that many of the new entities looking to set up REITs will not have the requisite experience at the REIT manager level. Hence, the manager level experience requirement should be waived, as long as the employee level experience requirement is adequately met.

Related Party Transactions

The Draft REIT Regulations have taken an extremely balanced approach to related party transactions. The following is a brief description of the restrictions on related party transactions that can be undertaken by a REIT:

Restrictions on Leasing

The leasing of REIT properties to related parties is subject to the following restrictions:¹³

- The area leased to a related party should not exceed 20 percent of the underlying area of the assets;
- The value of assets under such lease should not exceed 20 percent of the value of the total underlying assets;
- Rental income obtained from such leased assets should not exceed 20 percent of the value of the total rental income derived from the underlying assets;
- A fairness opinion is required to be obtained by the REIT manager and submitted to the trustee of the REIT in relation to such related party transactions;
- Additionally, all related party transactions, whether entered into prior to or after the initial offering, shall

require a full valuation of the property being purchased, with the average of the two valuations being the purchase price; and

- Full valuations of the property must be provided, along with the relationship and other ancillary details relating to the relationship of the parties concerned.

Unit Holder Approval for Related Party Transactions

Any transaction sought to be entered into by a REIT subsequent to the initial offer whose value exceeds 5 percent of the value/rental income/borrowings of the REIT requires the positive approval of 75 percent of the unit holders of the REIT by value and number, excluding the interested parties.

Suggestion

- **Unit holder approval threshold:** Although it is necessary for unit holder approvals in relation to related party transactions that a REIT proposes to enter into, the threshold to obtain 75 percent unit holder approval (by value and number) in case of a transaction, *i.e.*, 5 percent of the value/rental income/borrowings, appears low. With the 20 percent limit already in place for related party transactions, coupled with other restrictions in the context of related party transactions, the 5 percent limit should be reconsidered.

Voting Thresholds

The Draft REIT Regulations require unit holder approval in many potentially material transactions that the REIT may carry out. The thresholds for unit holder approval have been measured on the basis of value and number:

- Matters which require the approval of 60 percent of the unit holders (by value and number) include matters such as removal or appointment of a new trustee/manager/sponsor or principal valuer, change in control of the sponsor, as well as a requirement to delist the units of the REIT; and
- Matters which require the approval of 75 percent of the unit holders (by value and number) include matters such as any related party transactions, borrowings in excess of 25 percent of the value of the REIT assets, change in investment strategy, proposal by the sponsor or manager to delist units of the REIT, and if any unit holder (or associated persons) seeks to acquire more than 50 percent of the units of the REIT by value.

Suggestions

- **Voting requirements by value and number:** All actions relating to REITs as outlined in Clause 22 require approval from unit holders constituting a 60 percent or 75 percent consensus both by value and by number. It may be preferable to require approval only of unit holders present and voting. The thresholds should also be based on value and not number.

- **Exclusion of interested parties:** Regulation 22(12) of the Draft REIT Regulations excludes the votes of any related person (and associates of such person) to a given transaction from being considered for the issue at hand. Therefore, since interested parties are excluded from participating in the vote, the voting requirement for the 60 percent matters should be reduced to 51 percent (instead of 60 percent).

Delisting and Termination

Currently, Regulation 17 of the Draft REIT Regulations outlines the provisions for delisting of the units of a REIT. Delisting may be carried out in the situations outlined below. Upon the occurrence of such an event, the REIT will be required to apply to SEBI and to the stock exchange for permission to delist:

- the minimum public float falls below 25 percent of the total units of the REIT;
- the number of unit holders in the REIT (other than related parties) falls below 20;
- SEBI or a stock exchange requires the delisting of the REIT for violation of the listing agreements/any provision of law or in the interests of unit holders;
- the sponsor or the manager applies for delisting of units and receives the relevant approval from the unit holders; and
- the unit holders apply for delisting of units.

Suggestion

- **Clarifying the delisting and termination process for REITs:** In the case of listed securities of a company in India, delisting entails a buyout of the securities of the company by the promoter by way of a book building process. However, in the case of a REIT, it must be clarified that, in conjunction with the delisting of the REIT, its termination should also occur. Essentially, the delisting and the termination should happen simultaneously, and in such an event the REIT should sell off the assets of the REIT, which monies should be distributed to the unit holders. The existing delisting applicable for companies cannot and should not be made applicable to REITs.

Perpetual Investment Vehicles for REITs

In our experience, in the past, SEBI has insisted on a term being fixed for venture capital funds/alternative investment funds, even when the relevant regulations were silent in that respect. However, we understand that, in the present instance, SEBI may be comfortable with REITs being conceived as perpetual investment vehicles which can be terminated only in accordance with its terms, and, accordingly, SEBI may not insist on a fixed term maturity. This would be in line with the global practice, where REITs are structured as perpetual investment vehicles which do not have a fixed term of maturity.

The Road Ahead

Several issues need to be addressed to ensure optimum utilization of the regime:

Taxes on Transfer

Currently, most completed real estate assets will be housed in SPVs, and, due to substantial costs, the promoters of such SPVs (who will also likely be the sponsors of the REIT) may not be able to transfer such assets to REITs for investment purposes. Such costs will include 1) stamp duty on the transfer of land in the region of 6 percent to 8 percent; and 2) capital gains tax on the transfer. Promoters would not be able to transfer the real estate asset of the SPV at nominal value, as the ready reckoner value will be deemed to be the sale price received (under Section 50 C if the asset is held as a capital asset, or under 43CA if the asset is held as stock in trade). To that extent, stamp duty on such transfer to the REIT should be exempt. On the topic of capital gains, similar to the merger provisions (under Indian tax laws), insofar as the seller/promoter receives units of the REIT, tax should not be levied on the receipt of the units themselves. Capital gains tax can then be levied at the time of sale/redemption of the units of the REIT.

Tax on Acquisition of SPV

If the promoters were to transfer their shares in the SPV to the REIT, then in all likelihood such transfer would happen for a combination of cash and in kind (units of the REIT). We suggest that capital gains on the transfer of shares for the units of a REIT should not be treated as a “transfer,” and that capital gains tax be levied only when the units of the REIT are transferred. This is because there is no monetization on the receipt of the units of the REIT, especially considering that the promoter will be locked in to the extent of 25 percent for three years.

Tax on Distribution of Income from REITs

If the REIT holds the SPV, any distributions would be subject to corporate level tax at the rate of 30 percent (exclusive of surcharge and cess) plus a dividend distribution tax of 15 percent if the SPV seeks to distribute dividends. Hence, we suggest that the SPV (if held by a REIT) should be exempt from all corporate level taxes, distribution taxes and minimum alternate tax. Further, the REIT should be given a pass through status (in the same manner as venture capital funds as outlined in Section 10(23FB) of the Income Tax Act, 1961), ensuring only a single level of tax at the hands of the unit holder.

Tax on Trading in the Units of the REIT

Additionally, since REITs are required to be mandatorily listed on the stock exchange, the same lower rate of capital gains tax (between zero percent and 15 percent) should be afforded to the sale and purchase of units of a REIT (on payment of the securities transaction tax) in a stock exchange as provided to listed shares and units of mutual funds. Amendments will have to be made to the Income Tax Act, 1961 and Chapter VII of the Fi-

nance Act, 2004 (which set up the securities transaction tax regime in India).

Foreign Investments

For units of a REIT to be mandatorily listed, the first step will be to define units of a REIT as a security under the SCRA. Currently, units of a REIT may not even qualify as a “security.” The second step will be to amend SEBI’s foreign institutional investor (“FII”) and qualified foreign investor (“QFI”) regulations to allow portfolio investments in units of a REIT. The third step will be to amend the exchange control regulations to facilitate FIIs/QFIs to subscribe to units of a REIT. Capital account transaction rules will also need to be amended to exclude REITs from the definition of “real estate business,” as even foreign portfolio investment is not permitted in real estate business. Investment in yield generating assets may qualify as “real estate business.”

Conclusion

As REITs develop, health care, infrastructure and other stabilized yield generating assets may also be rolled into REITs. Such a framework was initially considered by the SEBI and will likely be the next progressive step.

However, the immediate need of the hour is to address the issues relating to tax and foreign investments, without which the REIT regime may not take off as contemplated.

NOTES

¹ Subsequently, SEBI instead sought to bring REITs through the SEBI mutual funds regime as a real estate mutual fund (“REMF”). However, the REMF could not take off due to issues relating to tax, restrictive investment and asset criteria and certain other conditions. Please see Nishith Desai Associates’ Hotline analyzing the REMF regime when it was introduced, titled “Will REMFs Outshine REITs?”

² Regulation 18 of the Draft REIT Regulations.

³ Clause 14(b) of the Draft REIT Regulations.

⁴ Clause 14(2) of the Draft REIT Regulations.

⁵ Regulation 16(4) of the Draft REIT Regulations.

⁶ Regulation 18(6) of the Draft REIT Regulations.

⁷ Regulation 21(4) of the Draft REIT Regulations.

⁸ Regulation 21(5) of the Draft REIT Regulations.

⁹ Regulations 49A(a)(v) and (vi) of the Mutual Funds Regulations.

¹⁰ Regulation 11(2)(b) of the Draft REIT Regulations.

¹¹ Regulation 11(2)(a)(i) of the Draft REIT Regulations.

¹² Regulation 11(2)(a)(ii) of the Draft REIT Regulations.

¹³ Regulation 19(7) of the Draft REIT Regulations.

The text of the draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2013 is available on the SEBI website at http://www.sebi.gov.in/cms/sebi_data/attachdocs/1381398382013.pdf.

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