

# Introduction of Regulatory Framework for Micro, Small & Medium REITs ('MSM REITs') – Draft Consultation Paper

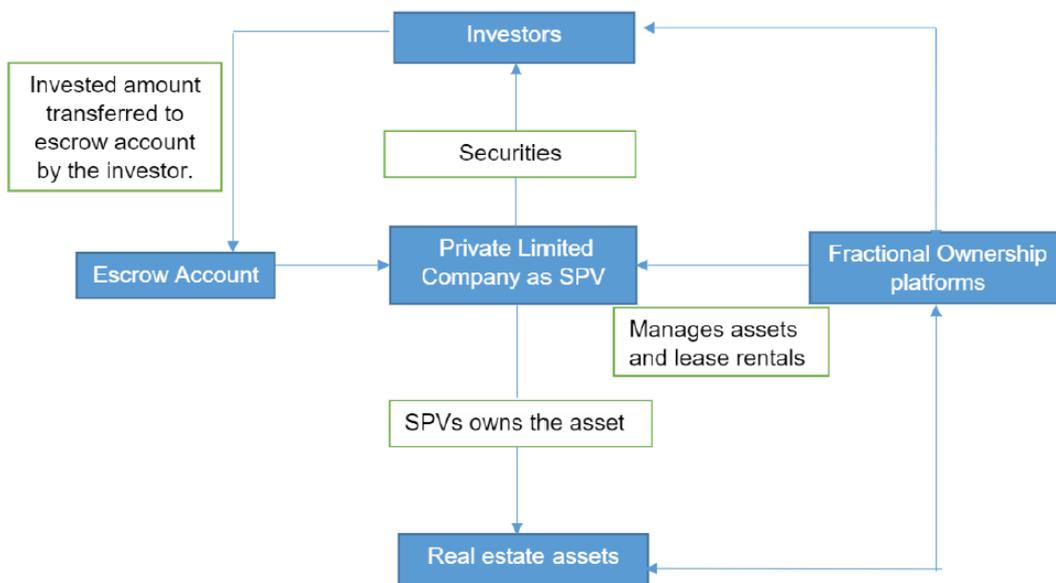
## 1. Background

- Over the last few decades, the real estate industry has come a long way forward and has witnessed development of not only stand-alone high rises but also large complexes and townships.
- In the past 2-3 years, there has been a mushrooming of web based platforms offering fractional ownership of real estate assets. These platforms are typically known as the Fractional Ownership Platforms ('FOPs') which provide the investors an option to invest in building and office spaces including warehouses, shopping centers, conference centres etc. These platforms are widely practiced across the globe especially in countries like United States and United Arab Emirates.
- Given the increasing value of investments, as well as rising number of investors, the regulators have considered necessary to have these FOPs registered and regulated in order to bring regulatory oversight, standard operating practices, bringing investor redressal mechanisms, adopting correct valuation, bringing certain disclosure standards etc. to ensure the investors are safeguarded.
- In this regard, the Securities and Exchange Board of India ('SEBI') has come up with a consultation paper requiring public view on the following aspects prescribed for regulating the FOPs.

## 2. Fractional ownership – An overview

- In general, investment in a real estate property is a capital intensive process, and requires an investor to invest huge amounts, limiting the sector of people to high net worth individuals/ higher middle class people etc. In addition to the capital intensiveness, a real estate investment requires other aspects such as market knowledge, ability to manage the property, identifying the premium tenants for a long term basis, legal aspects of the property etc.
- To address the above concerns, the concept of fractional ownership of assets have arose. Fractional ownership of assets through the FOPs ensures that the cost of acquiring these high capital intensive real estate assets split among multiple investors. For example, with a ticket size of say INR 20 lakhs per investor, a property worth INR 2 crores can be purchased by 10 investors through the FOPs.
- The process involves three persons/ entities, one is the Special purpose Vehicle ('SPV') which owns the real estate asset, the second is the FOP and the third is the individual investor.

- The process of investment and the manner of earning income out of the same is depicted in the below diagram:



- The transaction is structured as follows:
  - The property is first identified by the FOP.
  - The identified property is listed on the website of FOP seeking expression of interest from public with token amount ranging from INR 10,000 to INR 100,000.
  - On receipt of 100% expression of interest, the placement memorandum to subscribe to the securities issued by the private limited company (i.e., SPV which owns/ purchases the real estate asset) are forwarded to the investor.
  - The investor transfers the agreed investment amount to the escrow account.
  - The investors are allotted the securities.
- The above activities are undertaken without any regulatory oversight or is ambiguous as to whether these FOPs should register as real estate agents under the Real Estate (Regulation and Development) Act, 2016 ('RERA'). RERA lays down the responsibilities of a real estate agent, including maintenance of books, not getting into unfair trade practices etc. However, these responsibilities would not result in protection of investors as the context of RERA is significantly different from the operations of FOPs.
- SEBI had notified the SEBI (Real Estate Investment Trust) Regulations, 2014 ('REIT Regulation') in September 2014, which was mandatory to be listed on the recognized stock exchanges in India. REIT Regulation provides sufficient framework to the investor in terms of periodical return on their investments, valuation of the properties by appointing a registered valuer, prescribing entities which are eligible to register and raise funds and minimum number of subscribers etc.
- Considering the above framework being more suitable to address the current regulatory oversight in FOPs, the SEBI is planning to extend these REIT Regulations in the case of FOPs as well. The migration of the current SPVs or other structures established as FOPs to the REIT structure may result in treatment of such investment by investors as investment in Business Trusts as defined under the Income tax Act, which provides certain benefits which might not be available to other SPVs.

### **3. Investor concerns in current practice**

- Based on the consultation paper issued by the SEBI, it is observed that currently the following concerns may not be taken care by the FOPs considering that the same is unregulated:
  - Valuation of the real estate
  - disclosure made to the investor at the time of soliciting investment

- property title diligence and property title documentation
- lease, rental or tenancy documents and terms arrived at with the lessees/ tenants
- continuing disclosures including of receipts of lease payments, due payment of outgoings (such as property taxes, EB or water charges etc), cancellation or suspension of leases, status of lease renewals etc.
- Depending on the FOPs by investors for necessary information to aid diligence upon exit.
- KYC/ AML norms not applicable to the activities of FOPs and accordingly not complying with the guidelines of Prevention of Money Laundering Act guidelines.
- No uniformity or common approach on investor grievances i.e., absence of efficacy of independent review of redressal mechanism.

#### 4. Proposed scope of regulation

In order to address the above grievances/ issues faced by the investors, the SEBI has proposed to bring the FOPs under the regulatory ambit by introducing a chapter under REIT regulations and labelling these as MSM REITs. The key points of the proposed framework is given below:

S No	Particulars	Remarks
1	Compulsory Registration	<ul style="list-style-type: none"> <li>• Any person or entity (including FOPs) which facilitate or have facilitated fractional investment in real estate by any structure shall be required to register with SEBI for operating as MSM REIT.</li> <li>• The existing transaction structures should be migrated to MSM REIT.</li> <li>• Persons/ entities which do not meet the eligibility criteria or do not register shall wind-up their operations and cease to operate. Investors shall be provided with exit option within pre-specified period.</li> </ul>
2	Structure of MSM REIT	<ul style="list-style-type: none"> <li>• MSM REIT shall be set up as a Trust under the provisions of Indian Trusts Act, 1882 with an ability to establish distinct schemes for owning real estate assets through wholly owned SPVs as constituted under the Companies Act, 2013.</li> <li>• MSM REIT shall have 100% equity share capital and control in all SPVs. The SPVs will be required to hold 100% ownership in all the properties.</li> <li>• The MSM REIT will have parties namely – Trustee, Sponsor and Investment Manager<sup>1</sup> with each such person being a distinct entity.</li> </ul>
3	Operational & regulatory aspects	<ul style="list-style-type: none"> <li>• The MSM REIT and parties to the REIT should be fit and proper persons based on the criteria as specified in Schedule II of the SEBI (Intermediaries) Regulations, 2008.</li> <li>• MSM REIT will be permitted to launch schemes. Each Scheme will be identified by a separate name.</li> <li>• The units of the MSM REIT Schemes shall be mandatorily listed on stock exchange and will be held in demat form. Any investments of MSM REIT in SPV(s) shall also be in demat form.</li> <li>• Existing Persons/ Entities (including FOPs) shall ensure that each SPV formed by it is effectively transferred to an MSM REIT Scheme and investors who were issued securities by such SPV shall receive units of such MSM REIT Scheme.</li> </ul>

<sup>1</sup> Various criterias including network, experience in the industry, minimum holding in the scheme etc has been provided for a person/ entity to becomes an investment manager/ sponsor/ trustee, which needs to be satisfied by the fund to comply with the regulation.

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		<ul style="list-style-type: none"> <li>• MSM REIT shall not enter into any transaction with related parties (except for fees paid to investment manager and trustee).</li> <li>• Minimum disclosure requirements such as property wise disclosures of lease rental along with comparables of similar properties etc shall be prescribed by SEBI, which needs to be certified by an independent registered valuer of the fund.</li> </ul>
4	Fund raising restrictions	<ul style="list-style-type: none"> <li>• MSM REITS may raise funds from any investors, resident or foreign.</li> <li>• MSM REIT Schemes shall not be allowed to raise debt.</li> <li>• The MSM REIT Scheme shall raise funds from at least 20 Investors that are unrelated to the Sponsor, its related parties and its associates.</li> <li>• The minimum subscription size to the units and the unit size of a MSM REIT Scheme shall be INR 10 lakhs. The maximum subscription from any Investor (other than sponsor(s), its related parties and its associates) shall not be more than 25% of the total unit capital.</li> <li>• For initial offer of a scheme, the size of the asset proposed to be acquired should be at least INR 25 crores and should not exceed INR 499 crores.</li> </ul>
5	End use requirements	<ul style="list-style-type: none"> <li>• At least 95% of the scheme's AUM shall be invested in completed and rent generating real estate properties at all times.</li> <li>• The balance can be invested in unencumbered liquid assets such as money market instruments, government securities, T-Bills etc.</li> </ul>
6	Distribution of cashflow (Dividend/ interest payment)	<ul style="list-style-type: none"> <li>• Not less than 95% of net distributable cash flows of the SPV shall be distributed to the scheme of MSM REIT</li> <li>• The amount retained at the SPV level may be utilized only in the manner specified by the Board.</li> <li>• 100% of net distributable cash flows of the MSM REIT shall be distributed to the scheme wise unit holders.</li> <li>• SEBI shall specify the cap on total expense ratio for MSM REITS.</li> </ul>
7	Valuation of assets	<ul style="list-style-type: none"> <li>• Valuation of assets shall be carried out by a registered valuer.</li> <li>• A full valuation including a physical inspection of the properties and consequently, the declaration of NAV of each scheme shall be carried out on a quarterly basis.</li> <li>• Detailed disclosures are proposed to be specified for the quarterly valuation reports.</li> <li>• For any purchase or sale of property, a full valuation shall be required to be undertaken by the valuer. A safe harbour threshold of 2% is prescribed for such purchase/ sale. If the same is breached, approval of 75% unit holders would be required.</li> </ul>
8	Rights of investors	<ul style="list-style-type: none"> <li>• The investors shall have right to remove the investment manager, auditor, principal valuer, seek winding up of scheme etc.</li> <li>• Attend the annual meeting which shall be convened by the trustee wherein matters such as latest annual accounts, valuation reports,</li> </ul>

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		<p>performance of MSM REIT scheme, approval of auditors &amp; their fees etc shall be discussed.</p> <ul style="list-style-type: none"> <li>• Approval of investors shall be mandatory in case of change in Investment manager/ sponsor, change in investment strategy etc.</li> <li>• Person who is a party to any transaction as well as associates of such person shall not participate in voting on the specific issue.</li> </ul>

## 5. Way forward

- The proposed developments will eliminate entry barriers, increase diversification opportunities for investment, reduce financial burden and increase investor confidence, which will take the real estate industry forward.
- While the new regulation shall become an opportunity to enhance the overall investor and stakeholder proposition, this could become a costly affair for the SPV/ fund to comply with the stringent compliances including appointment of independent investment manager, sponsor/ trustee etc. as prescribed under the regulation.
- SEBI's consultation paper does not address the taxation aspects. It is expected that the taxation norms as applicable to regular REITs shall apply here.

Contact us at:

**M2K Advisors LLP**

7th Floor, Briley One,  
No. 30/ 64 Ethiraj Salai,  
Egmore, Chennai – 600 008,  
Tamil Nadu, India

[mukesh@m2k.co.in](mailto:mukesh@m2k.co.in), [vivek@m2k.co.in](mailto:vivek@m2k.co.in)

[www.m2kadvisors.com](http://www.m2kadvisors.com)

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