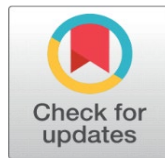


COLLECTIVE INVESTMENT IN REAL ESTATE: REITS UNDER THE SEBI – A LEGAL FRAMEWORK

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ABSTRACT

Real Estate Investment Trusts or REITs have become an important tool in India capital markets enabling investors to invest in real estate as an asset class in India without holding a property directly. REITs are simplified form of Collective Investment Schemes (CIS) and are regulated by the Securities and Exchange Board of India (SEBI). The purpose of this paper is to discuss the legal status of REITs in India, the reason for treating them as CIS and other issues including transparency, investor protection and development of real estate. In 2014, Securities Exchange Board of India (SEBI) introduced the REIT Regulations, 2014, which brought a major change in the regulation to institutionalize real estate investment without compromising investor interests. The following study examines the regulation, qualifications, compliance and investor rights under the REIT framework. Finally, it demonstrates the commonalities as well as the differences between CIS and REITs, and provides insight into the developing case law on collective investment schemes. The paper also delves into the challenges of implementation, such as tax inefficiencies, a liquidity trap, and the need for more respondents in the broader market. In essence, REITs, under the aegis of erstwhile SEBI regulation, represents the next logical step in the evolution of the principles underpinning CIS adapted to provide considerable benefits stemming from growth in the real estate sector us and offer Indian's access to investment opportunities not previously available in their own country.

Keywords: Real Estate Investment Trusts, India Capital Markets, Securities and Exchange Board of India (SEBI), Investor Rights, Developing Case Law

1. INTRODUCTION

Real Estate Investment Trusts (REITs) and Collective Investment Schemes (CIS) are structured vehicles to pool funds from investors and invest them into successful projects. Although both are used for collective investment and provide a way to manage multiple portfolio holdings simultaneously, the regulations governing the mechanics of their operation and the assets they hold are distinct. Real Estate Investment Trusts (REITs), in particular, give access to income-producing real estate assets including commercial properties, office buildings, shopping centers, and infrastructure assets that are owned and managed, relieving the burden of outright ownership and management from

the investor. In contrast, CIS typically involve a wider range of pooled investments including mutual funds, venture capital funds, and other such alternative investment funds.

Globally, the first introduction of REITs occurred in the U.S. as part of the 1960s, where they have become a major part of developed real estate markets. The concept was to allow smaller investors the ability to capture cash flows from large real estate projects which effectively democratized real estate investment. But India adopted this REIT model fairly late. The Indian realty sector for several decades exhibited features of being unorganized and opaque although there was an increasing desire for investments in real estate through institutionalized avenues. This was set changed with the rollout of the SEBI (Real Estate Investment Trusts) Regulations, 2014, which laid the initial structure of regulated REITs to function in the Indian Capital market.

Collective investment schemes (CIS), as defined under Section 11AA of the SEBI Act, 1992, are schemes where funds are collected from the public and invested on their behalf. In India, CIS have suffered from dearth of credibility over the years mainly because of the new-age fraudulent schemes that have come up and operated without regulatory oversight. Consequently, SEBI tightened the noose around CIS operators by asking them to be registered and comply with the regulations. REITs are similar to a collective investment model but are restricted to real estate and have a very transparent, listed-market.

One common philosophy behind the both of them is to democratize investment through REITs and CIS. They provide retail and institutional investors a wide range of possibilities to diversify their portfolio, reduce risk exposure and join markets that are usually in the hands of the big players. Meanwhile, such schemes can only succeed, if they enjoy the confidence of investors as well as regulatory oversight — and that is where SEBI also was playing a role.

Real estate investment trusts became intermediaries between the real estate developers (fund seekers) and investors (fund providers), which opened up a more structured investment channel for funding of real estate while the Indian context of REITs gave liquidity and returns to the investors. Their CIS-compliant structures release a tightly-tailored domestic regulatory environment — a notable local investment evolution. By virtue of being a separate category of investment product, a REIT is essentially a CIS with a high concentration in the real estate sector and as such, this paper wishes to explore the promise and pitfalls REITs hold out for the Indian capital and real estate markets.

2. REITS: ROLE OF SEBI & THE REGULATORY FRAMEWORK

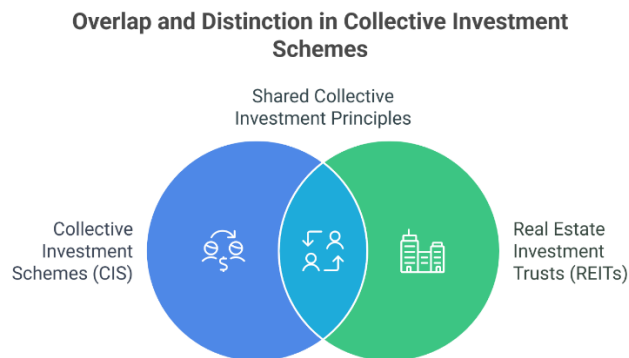


Figure 1 Overlap and Distinction in Collective Investment Schemes

Source: authors own creation.

In India, the regulatory framework for Real Estate Investment Trusts (REITs) are led by the Securities and Exchange Board of India (SEBI), which in 2014 enacted the SEBI (Real Estate Investment Trusts) Regulations. This regulation was a historic step for the American financial goal to create the groundwork, standard, compliance requirements and operating mechanisms of REIT to operate in a transparent and investor-friendly manner with the Indian capital market. The main goal was to create a regulatory environment that organized institutional investment in real estate, increased transparency, and provided protection to investors.

A REIT has to be established as a trust under Indian Trusts Act, 1882 and must be registered with SEBI per the REIT Regulations. A sponsor to create the REIT, a trustee to hold the assets for the benefit of investors, and a manager to

manage the REIT and its assets. The REIT has to be listed on a major stock exchange so that it can be traded, allowing its price to be determined via a market mechanism.

This regulatory framework forces the REIT to invest a minimum of 80% of the value of REIT assets in completed & profit generating properties, which reduces the risk associated with construction & offers fixed revenue-generating returns on a consistent basis to the investors. In addition, REITs must distribute a minimum of 90% of unit holders' net distributable cash flows, and this drives regular income. Such features reconcile REITs with the classic pooled investment model while adjusting it to the characteristics of the real estate market.

REITs undoubtedly cater to all classes of investors, i.e. retail, institutional and foreign investors alike. SME companies had kept the minimum subscription and lot size initially at very inflated prices but SEBI revised it to attract more of retail participation. This is one of the indicatives, which shows that SEBI dynamic is aiming for wider participation of investor base to be part of real estate market.

The regulatory framework, on the other hand, includes strict provisions for disclosure and compliance. Regular disclosures are made by REITs on financials, asset performance, lease agreements, occupancy, and valuation reports. The REIT manager has to appoint a registered valuer to conduct periodic valuation of redeemable assets. Such transparency measures are critical in allowing investors to remain confident and make informed decisions.

In the same light, SEBI has also specified the limits of investment to avoid over-concentration and indulge in necessary risk mitigation. This means restrictions such as not being able to invest over 20% of total assets in under-construction properties or securities associated with real estate. These limitations on investment activity discourage speculative investment behavior and tie the vehicle to productive, income-generating assets in the real economy.

3. TYPE OF CIS IN INDIA: REITS

Although Real Estate Investment Trusts (REITs) fall under a separate regulatory framework under SEBI, the basic principles tie them closely to Collective Investment Schemes (CIS). Both these structures have the same underlying investment philosophy where they pool the money from multiple investors and help them invest in the prescribed set of assets to earn returns. Nonetheless, REITs are lightly regulated and legally faceless version of CIS, although a sectoral, ring-fenced product, grounded in the historical needs due to the threats of unregulated and fraudulent collective schemes in the former Soviet Union.

A CIS has four essential characteristics (1) pooling of funds (2) investment of those funds in a scheme; (3) fund management of contributions owned by or for the benefit of the scheme; and (4) day-to-day control of management not by investors over contributions to the scheme (the first three being the elements to be satisfied in order to bring the fund under the definition of CIS)(for the second being its exclusion from the definition of CIS under the first).¹⁰ The defining characteristics of CIS operate under the SEBI Act, 1992, under SI 11AA. All these conditions are met by REITs — the money is pooled from investors, deployed into earning-assets, managed by their professional companies while investors just own the units in the REIT and have no control over the operation. In this sense, REITs are simply sector-specific embodiment of CIS with additional safeguards and governance features.

In sharp contrast to standard CIS, often opaque and abused by unscrupulous promoters, REITs are both publicly listed and well regulated. Listing requirements guarantee market-driven prices, liquidity, and disclosures from which investor confidence benefits. Additionally, the fact that REITs can only invest in real estate or real estate-related assets, whereas traditional CIS had wider and often vague objectives, created opportunities for regulatory arbitrage and investor losses.

Given this knowledge, it was also quite clear to SEBI that a separate legal and regulatory architecture was needed for REITs as compared to CIS for the purpose of creating a credible and effective real estate investment ecosystem. While REITs and CIS are analogous in their structure and purpose, REITs provide a more mature and investor-oriented vehicle by capitalizing on market development and regulatory protection.¹¹ They also fit in neatly with international investment norms aiding ease of foreign institutional investment and aiming at the objective of financial globalization for India.

Legally, REITs are not considered as CIS because of their registration under certain SEBI regulations. This distinction becomes important because CIS has been tarred in the past with the same brush as other systems, and this happens in a context of such historical baggage in India. However, the basic principle of mutual funds, which is essentially collective investment and risk sharing and pooled funds management, is related to the two concepts.

In addition, REITs have contributed to changing the perception of investing as an institution-wide stake in India. CIS were generally looked upon with an element of suspicion, but REITs are fast gaining acceptance as safe, transparent and efficient vehicles for long term capital for the real estate industry. They embody the collective investment that can be reinvented, but only with adequate regulatory safeguards, an equitable housing sector and robust institutional participation.

In brief, REITs can be called as a regulated, enhanced and sectorial CIS in India. The emergence of this is indicative of SEBI being proactive in providing a strong investment environment while avoiding the erratic regulatory scenario facing CIS in the past when the models of CIS were unregulated and hence were adversely managed at times.

4. COMPLIANCE, TRACEABILITY AND GOVERNANCE FEATURES

Real Estate Investment Trusts [REITs] are required to adhere to a series of stringent eligibility, compliance and governance norms in India and these indicators ensure transparency, investor confidence and market integrity. The regulatory provisions in this regard are enshrined in the REIT Regulations, 2014 issued by the Securities and Exchange Board of India (SEBI), and are updated from time to time to keep in line with the market dynamics and international best practices.

A trust formed under Indian Trusts Act 1882 can only be offered as a REIT in India. The trust has to be registered with SEBI and has to be managed by a SEBI registered manager. The REIT structure usually consists of three main issuer parties — the Sponsor, the Trustee, and the Manager. The REIT is organized by the Sponsor who is required to possess at least 15% of the REIT aggregate units for a period not less than three years. The Trustee is an independent third-party that holds the REIT assets on trust for the benefit of the unit holders, thus compliant with fiduciary duties. This individual handles the day to day and the asset management, so it is important that he / she has a minimum net worth and a rap sheet of experience in real estate and fund management.

The compliance mandates are put in place to maintain the financial integrity and limit the risks. REITs are required to invest a minimum of 80% of their assets in completed and income generating real estate projects, and the remaining 20% can be used to buy under construction properties, equity shares of listed companies in real estate sector or mortgage backed securities. This regulation is meant to limit exposure to construction risk and speculation.

On the financial compliance side, REITs have to declare a minimum distribution of 90% of their net distributable cash flows (NDCF) to unit holders on a semi-annual basis. Which is why, the investors can be paid periodically like dividends in equity markets. This is why REITs are required to report audited financial statements, property appraisals and portfolio information at regular intervals to promote greater transparency and allow for informed investing decisions. Every financial year, a registered and independent valuer must assess the assets.

In addition, governance mechanisms enhance the accountability of the REIT entities. The Manager must ensure that at least 50% of its board of directors are independent directors, promoting oversight and reducing conflicts of interest. Trustee independent of Sponsor and Manager to provide fiduciary architecture. Additionally, the SEBI have mandated the REITs to have adequate internal control systems, strong grievance redressal mechanisms and related-party transaction policies.

5. CHALLENGES/LIMITATIONS OF INDIAN REIT MARKET

While the potential of REITs looks promising, and the regulatory environment is quite strong in India, the REIT market has been plagued with multiple challenges and constraints, impacting its complete growth. All these impediments arise from the legal financial structural and operational landscape on which the domestic REIT market has managed to build its way over the years which still stays at its infancy when benchmarked against the well-established global markets.

A major trouble is the dearth of deemed commercial real assets that qualify as per the regulations prescribed by SEBI. In India, at least 80% of the REIT assets should be in the form of income-generating, completed properties according to SEBI. Still much of the available real estate remains unreached, because of splintered title chains, regulatory conflicts or imperfect land records. Transparency in property valuations and inconsistent rental yields further constrict the pipeline for REIT-worthy assets in tier-2 and tier-3 cities.

Taxation is another important issue which affects REITs and investors in REITs. However, while some tax benefits have been passed through to REITs, including pass-through status for interest and dividend income, for example, taxation on capital gains, distribution income and stamp duties continues to be a disincentive. In addition, frequent tax policy changes and ambiguity with respect to characterisation of certain other distributions exacerbates investor fears.

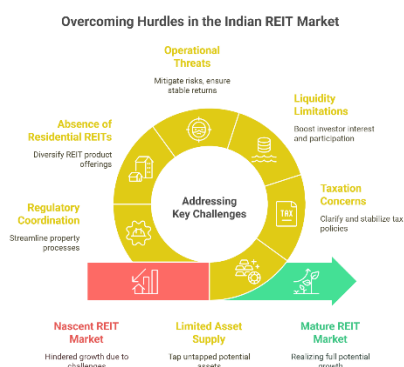


Figure 2 Overcoming Hurdles in the Indian REIT Market.

Source: authors own creation.

Another constraint is that of liquidity. Global REITs have significantly more depth in terms of volumes traded and little liquidity cushion between high-net-worth investors due to competition for eye-catching discounts that retail investors can create for high-net-worth investors. Indian REITs need to liquidate this bigger pool at lower-cost rates, attracting less attention than global REITs. (Price difference between the East and the West) Even though SEBI reduced the minimum investment as well as trading lot size, retail participation has not been as strong as expected largely due to lack of awareness and aversion to risk towards real estate instruments.

More problems such as valuation differences, occupancy rate and tenant defaults still persist, bringing business operational risks as well. As REITs are significantly dependent on rental revenue for commercial properties, cash flows and return can be adversely affected due to an economic slowdown, changing workforce (such as the temporary remote working condition post-COVID) and tenant bankruptcy.

Also, lack of residential REITs in India stifles the existence of a diversified REIT product. Although international markets have multiple flavors of REITs from residential, industrial, retail, data center and healthcare, Indian markets also generally have REITs focused on commercial office spaces only which further narrows the opportunity to expand.

6. CONCLUSION

Real Estate Investment Trusts (REITs) are an innovative addition to the Indian investment landscape with potential to institutionalize a new type of real estate investment that can open up the door for household investors to this traditionally high capital intensive sector. REITs have set the stage with greater transparency, investor protection, and capital allocation efficiencies in the real estate market, aided by the same SEBI regulatory framework. But the road is still long to go, Embassy REIT, Mindspace REIT, and Brookfield REIT have seen a healthy flight of capital and investment flows to date, but it only signifies low hanging fruits in commercial and residential spaces remain largely untapped.

REIT posited Collective Investment practice which was unregulated as mentioned earlier, towards a formal, regulated, and publicly-traded alternative to collective investment. Trust is quintessentially important especially in India where investor confidence in pooled investment schemes has repeatedly suffered due to scams and frauds in the CIS space. REITs, by providing regulated exposure to income-generating assets coupled with mandatory distributions and strict compliance standards, are a reformed version of the collective investment structure.

So, policy and tax reforms are necessary to increase the participation rate. Further, if our stamp duties can be reduced or justified, if tax neutrality can be assured across all modes of distributions, if at the same time the tax position is clear for the longer term, the overall measures will not only make money seek the Fund but will also bring back local retail investors too. Banks should also promote listings of REITs for various subsectors (residential and other REITs (warehouses, healthcare and data centres) to broaden and deepen the market.

Financial education and awareness also has a big part to play. Lack of Awareness and Understanding of REITs — There is a significant portion of potential investors, particularly in the retail segment, who are still not familiar with the advantages, disadvantages, and operating mechanisms of REITs. A large investor base can be built up considering that awareness campaigns targeted towards investors and inclusion of REITs in financial literacy programs are undertaken.

The growth of REITs will be further supported by infrastructure development and regulatory modernization. Simplifying land acquisition, digitizing records of land, property and ownership, and providing transparency regarding rules for leasing and tenancy can enhance investor confidence and reduce the operational risk faced by REIT managers.

In terms of governance, it is important to keep SEBI regulations at par with global best practices, while continuously tracking and adapting to ever changing global perspectives. Mature markets — the U.S., Singapore, and Australia — which have propelled REITs into near permanent positions in the institutional portfolio, have lessons to share that the Indian REIT model can learn from. This consistency will enable the inclusion of Indian REITs in global indices while also paving the way for foreign portfolio investment by integrating domestic frameworks into international standards.

CONFLICT OF INTERESTS

None.

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