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Real estate liquidity crisis - Are REITs the answer?

To infuse liquidity in the real estate sector and provide more funding options to debt-laden developers, SEBI, for the second time, released a consultation paper and draft regulations (**"Draft Regulations"**) on Real Estate Investment Trusts ("**REITs**").

The Draft Regulations prescribe that REITs would be structured as trusts, to be registered with SEBI and would mandatorily be required to list their units on stock exchanges. To ensure serious players set up REITs, the minimum value of assets to establish a REIT has been proposed at Rs. 1000 crore. Further, for retail participation, the minimum subscription amount has been kept at Rs. 2 lakh per investor as opposed to Alternative Investment Funds, where the minimum subscription amount is Rs. 1 crore. The Draft Regulations require 90% of the REIT assets to be invested in "*completed and rent generating properties*". A property would be considered as "*rent generating*" only if 75% of its area is rented or leased out. REITs are not permitted to invest in vacant land, agricultural land and mortgages.

REITs are investment vehicles which provide real estate developers with an exit opportunity for their completed commercial projects. The developers may use REITs to offload their stakes in such projects and utilize the proceeds to pay off creditors or towards funding fresh development. Further, listed units of REITs may be attractive investment options for investors who desire stable return from rental accruals and seek appreciation of value of immoveable property.

However, implementation of REIT structure in India will have to encounter some regulatory challenges like; (a) incidence of double taxation of investors and the trust; (b) exchange control restrictions for investment in REITs (currently foreign investment in Indian trusts require prior approval of the FIPB), and; (c) legal uncertainties in relation to transfer of property to the REIT and winding up of such REITs. A favourable resolution of the above challenges would develop the REIT market in India.

Lightening the grays in the Takeover Code

An Adjudicating Officer of SEBI passed an Order in respect of Bhavook Tripathi on 1 October, 2013, in the matter of M/s R System International Limited. It touched upon an interesting gray area of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 ("**1997 Code**"), one on which there has been ample debate.

The issue is of whether placing of a buy order, by a shareholder on the cusp of the open offer threshold under the 1997 Code, and subsequent netting-off, through sale of such shares on the same trading day, would constitute a valid trigger for open offer obligations by such acquirer.

Mr. Tripathi held 14.96% shares of R System International ("**Target Company**") as on July 28, 2011. On the same day, on learning about the press release issued by SEBI announcing its decision to increase the initial threshold for making an open offer from the existing limit of 15% to 25%, he placed an order to acquire an additional 2.1% of the paid-up share capital of the Target Company, from the open market. On realizing that the new limits had not been notified yet, he sold such additional shares on the same day, prior to taking delivery.

The issue that arose was whether such netting-off could still trigger Regulation 10 of the 1997 Code, since the *acquisition* had not *entitled* the acquirer to exercise the voting rights associated with such shares to the tune of 15% or above, of the voting rights in the target company. It was argued that the settlement cycle had not resulted in delivery and consequently, the acquirer's name was not registered as a beneficial owner of such shares. Further, it was submitted to SEBI that intra-day netting off of the trade could not result in it mandating the acquirer to make an open offer, since the conditions of Regulation 10 had not been met.

Notably, SEBI accepted this as a valid contention, noting that it had been a consistently accepted interpretation that even if an acquisition exceeded 15% of a company's paid-up share capital, Regulation 10 would not be attracted *unless* the acquisition entitled such acquirer to exercise 15% or more of the voting rights in the company. The decision exonerated the investor of any wrongdoing, thus imparting a certain degree of certainty to one of the several vexed questions in the jurisprudence of takeovers.

Disclosure: Finsec Law Advisors appeared for Mr. Bhavook Tripathi in these proceedings.

Unlisted companies listing abroad

Unlisted companies incorporated in India could not list their securities directly on overseas markets without already being listed or simultaneously being listing on an exchange in India. The Ministry of Finance's Press Release of 27 September, 2013 states that the Government has approved-in-principle, such overseas listing without prior listing in India. While increasing the capital raising avenues available to unlisted entities, such listing is conditionally permitted on a pilot basis for a two-year period and the shareholdings are subject to extant FDI regulations. Listing abroad can be done only on exchanges in broadly those jurisdictions that comply with certain standards of International Organization of Securities Commission/ Financial Action Task Force. Companies are required to be in compliance and file a copy of the return that is submitted to the proposed exchange to SEBI for Prevention of Money Laundering Act. In addition to the disclosure requirements of the primary exchange and those of the jurisdiction in which they propose to list, companies have to follow disclosure norms of SEBI as well, before listing abroad. A welcome measure allowing Indian companies to attract foreign funding, the capital raised may be used to clear overseas debt or for activities abroad, including acquisitions. However, regulatory concerns persist that the proposed move may result in money laundering, since it is apprehended that untaxed money could be routed out of India, applied in issues of Indian companies abroad and brought back as legitimate money. If the funds are not used as prescribed, companies are mandated to remit them to India. The Ministry of Finance, DIPP and the RBI will issue necessary notifications to enforce the modifications to existing rules and only when notifications are issued will the procedure and nuances of the move be clear.

Better Enforcement of Listing Agreement Requirements

Where listed companies have failed to comply with the requirements under the listing agreement, stock exchanges usually resort to suspension of trading in shares of the offending company, as an enforcement mechanism. While this might seem an effective enforcement mechanism, the collateral damage caused to investors is unacceptably large, as it deprives them of the only exit route available. This grievance was finally addressed by SEBI, in its Circular dated 30 September, 2013, when it utilised its power to amend bye-laws of stock exchanges and incorporated a fine-based structure, including prescribing a standard operating procedure in the event of non-compliance. These are welcome additions to the enforcement mechanism as they introduce consistency and uniformity of approach amongst the stock exchanges.

There are two major benefits. First, there is a shift to a multi layered enforcement mechanism along with differential treatment of repeat offenders. The first layer will be imposition of fine for every day of non-compliance. Although the fine is a relatively small amount (thousand rupees a day for most offences), non-submission of shareholding patterns or financial results for more than 15 days attract a higher penalty of either 0.1 % of the paid-up capital of the entity or Rs. 1 crore, whichever is less. Continued non-compliance would result in restricting the trading of shares only to non-promoters and only on “trade for trade” basis. Further non-compliance would result in suspension.

These amendments to the listing agreement merely restrict liquidity in scrips of non-compliant companies as opposed to complete suspension of the trading of the shares. This would allow genuine investor interests to be protected due to non-compliance by the management of the listed entities. Further, since promoters of such non-compliant entities are restricted to participate in the trade for trade window, it would assist in the freezing of promoter shareholding during the period of non-compliance.

Green Light for Options

SEBI, on 3 October, 2013, by a notification under Sections 16 and 28 of the Securities Contracts (Regulation) Act, 1956, removed the uncertainty over forwards and options contracts in securities. It rescinded a previous SEBI notification dated March 1, 2000, which banned all forwards and options in securities, barring a few exceptions such as spot delivery contracts, contracts traded on exchange, certain pre-emption rights, warrants and convertibles and securities of private limited companies. Although this notification applies prospectively, it brings a cheer to several domestic and foreign private equity and early-stage venture capital investors who were apprehensive about bringing money to India. The 2000 circular while intending to ban certain kinds of speculative trades ended up with the unintended consequence of banning clauses of pre-emption rights and contracts for pre-emption, rights of first refusal, or tag-along and drag-along rights contained in shareholders agreements. These would now be valid and enforceable. To validate such clauses in shareholders' agreements or articles of association of companies SEBI has prescribed three pre-requisites: a) The title and ownership of the underlying securities is held continuously by the selling party for a year; b) the price or consideration must be determined in compliance with all laws, and c) there must be actual delivery of the underlying securities for the settlement of the contract. Subject to the fulfilment of these three conditions, such contracts would be valid and enforceable.

However, there is some ambiguity regarding the applicability of the new law to securities of public unlisted companies. The judiciary has hitherto interpreted the prohibition broadly and thus options even in unlisted shares of a public company have been considered invalid. Extending the prohibition to unlisted securities does not serve any purpose. It would have been a progressive move to restrict the prohibition to only listed securities where there is any public shareholder concern. Further, prospective operation means that past agreements would still face the challenge of the old and perverse law. Such investors would probably aim to repeal their old agreements and sign new identical ones to protect themselves. This should, ideally have been avoided, as all investors ought to have been allowed the protection of the new law.

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