

## **Investment by Mutual Funds in Alternative Securities**

### **1. Objective**

1.1. The objective of this memorandum is to place a proposal for amendment to SEBI (Mutual Funds) Regulations, 1996 (MF Regulations) and circulars issued there under with respect to investments by Mutual Funds in asset classes which cannot be specifically classified as debt or equity.

### **2. Background**

2.1. Mutual Fund is a professionally managed investment vehicle where the funds are deployed as per the given investment objective and strategy of a scheme in a way that provides a prudent spread of risk.

2.2. Retail investors find it easier to achieve diversification through investment in units of Mutual Fund Schemes rather than through ownership of individual stocks or bonds.

2.3. Pursuant to the notification of SEBI (REIT) Regulations, 2014 and SEBI (InvIT) Regulations, 2014, SEBI is in receipt of applications for registration as REITs and InvITs. The prospective investors in the units of REITs/InvITs include Mutual Funds.

2.4. REITs and InvITs are set up as trust under the provisions of Indian Trusts Act, 1882 and registered with SEBI. The Trust (REIT/InvIT) holds the assets either directly or through SPVs. The value of assets owned by REITs /InvITs is required to be at least INR 500 crore. REITs/InvITs are required to distribute not less than 90% of the net distributable cash flows, subject to applicable laws, to its investors. The unit holders of REITs and InvITs do not have a direct ownership in the assets of the company but are beneficial owners of the properties held by the Trust. The key features of REITs and InvITs are placed at ANNEXURE A.

2.5. As per Regulation 43(1) of SEBI (Mutual Funds) Regulations, 1996, Mutual Funds are allowed to invest in securities. Units of REITs and InvITs fall under the inclusive definition of 'securities' under Section 2(h) of Securities Contracts (Regulation) Act,

1956. Generally, Mutual Funds invest in securities which can be categorically classified as debt, equity or gold instruments.

2.6. A mutual fund scheme is classified as debt or equity scheme based upon whether the underlying securities are predominantly debt or equity instruments. Accordingly, for investment by Mutual Funds in REITs/InvITs, the appropriate investment bucket that REITs/InvITs belong to, needs to be identified based on the characteristics of REITs/InvITs.

### **3. Classification of REITs and InvITs as a separate asset class**

3.1. When analysed the following observations lead us to believe that REITs/InvITs does not clearly belong to equity securities or debt securities.

3.2. Cash Flows and Dividends - The requirement to distribute 90% of cash flows of REITs and InvITs to unit holders does not entail a fixed coupon or guaranteed return of principal obligations to investors. The requirement is akin to having a dividend distribution policy in equity securities, but are a mandatory requirement unlike equity securities.

As the product does not have any fixed obligation to the unit holders, the 'Unit' itself does not carry a rating. Hence, given that there is no repayment, security or any charge on the assets of the REITs/InvITs, it does not possess all the characteristics of debt securities.

#### **3.3. Taxation structure**

- Trust

REITs and InvITs have unique characteristics dissimilar from common stocks. They are the pool of several individual properties or infrastructure assets, have a unique tax structure where the trust pays no tax and are not a company registered under the Companies Act.

- Returns on investments in REITs and InvITs

The taxation structure of returns of investments in REITs/InvITs also points towards the hybrid nature of these instruments. The taxation structure is a combination of equity and debt such that the rate of capital gain taxation is similar to that of equity

securities while the holding period for classification of capital gains as short term or long term is in line with that of debt securities.

### 3.4. NAV and Voting Rights

- REITs and InvITs are predominantly income generating products with the objective to earn and distribute the rental income or revenues earned to the unit holders. The NAV is calculated based on the valuation (done once in six months) of the underlying assets.
- The voting rights of unit holders of REITs/InvITs are limited to only certain operational decisions when compared with that of equity shareholders of companies. Hence, it does not mirror all the characteristics of equity securities.

3.5. Further, the use of tenancy and lease information to map real estate to equity and debt market factors can be important in forming a view on a property's expected return but these factors fail to capture real estate risk. Although there is commonality with both debt or equity securities in certain aspects, majority of real estate risk is driven by endogenous factors. It is for this reason that Real Estate Mutual Fund Schemes and Infrastructure Debt Funds have separate chapters under SEBI (Mutual Funds) Regulations, 1996 with additional investment restrictions and eligibility criteria.

3.6. It is for the above mentioned reasons that a hybrid asset class for investment by Mutual Funds in such products was felt necessary.

## **4. Listing and Trading of REITs and InvITs - Liquidity Concerns and Systemic Risk**

4.1. REITs and InvITs are set up as 'trusts' under the provisions of Indian Trusts Act, 1882. REITs would raise funds through an Initial Public Offer (IPO) while InvITs will raise funds through IPO or private placement. After the IPO, it shall be mandatory for all units of REITs and InvITs (whether publicly issued or privately placed) to be listed on a recognised stock exchange having nationwide terminals. After the listing of REITs and InvITs, the same will be traded in the exchange platform.

4.2. Considering that REITs and InvITs are new category of securities, the volume of trading as well as the market depth in REITs and InvITs are still unknown. Real estate and infrastructure sectors are a potential sources of volatility and systemic risks. Accordingly, even the liquidity in these products is still unknown in the context of Indian securities market. Liquidity of securities held by a MF is important in light of the redemption requests that are regularly received by MFs.

## **5. International Practices**

5.1. A perusal of prospectus of some of the global funds in the United States of America (USA), Australia and Thailand, indicates that the intent to invest in REITs and InvITs is disclosed separately and is not clubbed with debt or equity securities.

5.2. USA- Prospectus of Blackrock Global Allocation Fund-The prospectus of Blackrock Global Allocation Fund reads as “Equity securities include common stock, preferred stock, securities convertible into common stock, rights and warrants or securities or other instruments whose price is linked to the value of common stock.....The Fund may buy debt securities of varying maturities, debt securities paying a fixed or fluctuating rate of interest, and debt securities of any kind, including, by way of example, securities issued or guaranteed by the U.S. Government or its agencies or instrumentalities, by foreign Governments or international agencies or supranational entities, or by domestic or foreign private issuers, debt securities convertible into equity securities, inflation-indexed bonds, structured notes, credit-linked notes, loan assignments and loan participations. In addition, the Fund may invest up to 35% of its total assets in “junk bonds,” corporate loans and distressed securities. The Fund may also invest in Real Estate Investment Trusts (REITs) and securities related to real assets (like real estate- or precious metals-related securities) such as stock, bonds or convertible bonds issued by REITs or companies that mine precious metals.”

5.3. USA- Prospectus of Goldman Sachs International Equity Insights Fund

The prospectus of Goldman Sachs International Equity Insights Fund read as “The Fund will be subject to the risks associated with equity investments. Equity Investments may

include common stocks, preferred stocks, interests in REITs, convertible debt obligations, convertible preferred stocks, ....”

#### 5.4. Thailand- Prospectus of TMB Property Income Plus Retirement Mutual Fund

The Sector Allocation of TMB Property Income Plus Retirement Mutual Fund is as follows:

- Foreign REITS :54.88%
- Local property Fund: 13.44%
- Local Infra Fund : 11.57%
- Local REITS: 9.27%
- Unit Trust: 2.76%

As seen above, investments by a Fund in REITs and InvITs are classified as a separate asset class which has a special mention in the Prospectus.

#### **6. Classification of REITs and InvITs by other Regulators:**

Pension Fund Regulatory and Development Authority (PFRDA)/ Employees’ Provident Fund Organisation (EPFO)/ Non-Government Provident Funds, Superannuation Funds and Gratuity Funds have classified investment in REITs and/or InvITs as a separate asset class and not clubbed with limits for debt or equity securities and the members are permitted to invest in InvITs and/or REITs up to 5% of assets managed.

#### **7. Category of Alternative Securities:**

With the evolution of Indian Capital Markets, new products that cannot be strictly classified as equity or debt will emerge. Hence such new hybrid products may be clubbed under the category of ‘Alternative Securities’. Currently, alternative securities shall include only REITs and InvITs. Any addition of new products to this category will be notified from time to time.

## **8. Changes in the Fundamental Attribute of the Scheme and Investment Restrictions:**

8.1. REITs and InvITs Investments form a separate asset class with separate risk return profile and investments by existing Mutual Funds schemes in units of REITs and InvITs would affect the interest of the investors. Accordingly this would constitute a change in the fundamental attribute of the scheme and, thereby, attract the provisions of Regulation 18 (15A) of SEBI (Mutual Funds) Regulations, 1996 which states that no change in the fundamental attribute of the scheme shall be carried out unless a written communication about the proposed change is sent to each unitholder, an advertisement is given in newspaper and the unit holders are given an option to exit at the prevailing NAV without any exit load. Therefore, it is imperative that unit holders of MF schemes are informed before a Mutual Fund scheme invests in REITs and InvITs.

8.2. Real estate and infrastructure sectors are a potential sources of volatility and systemic risks. Further given that Mutual Funds are pass through retail oriented investment products and there is a need to protect the interest of small and retail investors, it may be appropriate to introduce investment restrictions for Mutual Funds investing in REITs and InvITs.

8.3. In view of the above, the following investment restrictions for Mutual Funds investing in Alternative Securities were proposed:

- a. A Mutual Fund scheme shall not invest more than 5% of its NAV in units of a single issuer of alternative securities. Such limit of 5% shall not be applicable for investments in case of index fund or sector or industry specific scheme pertaining to alternative securities.
- b. A Mutual Fund scheme shall not invest more than 10% of its NAV in units of alternative securities. Such limit of 10% shall not be applicable for investments in case of index fund or sector or industry specific scheme pertaining to alternative securities.
- c. No Mutual Fund under all its schemes shall own more than 10% of units issued by a single issuer of alternative securities.

## **9. Recommendations of Mutual Funds Advisory Committee**

9.1. The Mutual Funds Advisory Committee (MFAC) in its meeting held on 23rd December, 2016 deliberated upon the issue and agreed that a new asset class of 'Alternative Securities' may be introduced for the purpose of investment by Mutual Funds in securities that cannot be strictly classified as equity or debt. Currently, alternative securities shall include only REITs and InvITs.

9.2. MFAC also agreed upon the investment restrictions (mentioned at SI no 8.3 above) for Mutual Funds investing in Alternative Securities.

**10. Cost-benefit Analysis:** Introduction of single issuer exposure limit and introduction of group level exposure limits for investment in alternative securities is likely to mitigate risks arising on account of high levels of exposure in the wake of unforeseen events. Not only does it put Mutual Funds in a better position to handle adverse credit events but also provides mutual fund investors with enhanced diversification benefits.

## **11. Proposals**

11.1. In view of the above, the following is proposed:

- a. Introduction of a new asset class of 'Alternative Securities' for the purpose of investment by Mutual Funds in new products that cannot be strictly classified as equity or debt. Currently, alternative securities shall include only REITs and InvITs. Any further additions may be notified by SEBI from time to time.
- b. Investment restrictions for Mutual Funds investing in Alternative Securities as given below:
  - A Mutual Fund scheme shall not invest more than 5% of its NAV in units of a single issuer of alternative securities. Such limit of 5% shall not be applicable for investments in case of index fund or sector or industry specific scheme pertaining to alternative securities.
  - A Mutual Fund scheme shall not invest more than 10% of its NAV in units of alternative securities. Such limit of 10% shall not be applicable for investments in

case of index fund or sector or industry specific scheme pertaining to alternative securities.

- No Mutual Fund under all its schemes should own more than 10% of units issued by a single issuer of alternative securities.
- c. The aforesaid investment restrictions at (b) shall be applicable to all fresh investments by all schemes.
- d. Any existing scheme intending to invest in units of Alternative Securities shall abide by the provisions of Regulation 18 (15A) of SEBI (Mutual Funds) Regulations, 1996.

**12.** The Board may consider and approve the proposals at para 11 and authorize the Chairman to take steps to implement the proposal by amending the SEBI (Mutual Funds) Regulations, 1996 and/or issuance of circulars, wherever necessary, with consequential and appropriate changes, as may be required, and to notify the necessary regulations, issue guidelines and circulars in this regard.

## Annexure A

### Key Features of REITs and InvITs

The key features of REITs and InvITs are as follows:

<b>Features</b>	<b>REITs</b>	<b>InvITs</b>
Eligibility Criteria	REITs to be set up as 'trusts' under the provisions of Indian Trusts Act, 1882. It would raise funds through an Initial Public Offer.	InvITs to be set up as 'trusts' under the provisions of Indian Trusts Act, 1882. It would raise funds through an Initial Public Offer or private placement.
Structure	The sponsor shall set up the REIT and appoint the trustee of the REIT. A Trust (REIT) is formed which holds the assets either directly or through SPVs	The sponsor shall set up the InvIT and appoint the trustees of InvIT. A Trust (InvIT) is formed which holds the assets either directly or through SPVs
Eligibility and Registration	Any person who wishes to carry on the activities of a REIT would have to obtain registration from SEBI	Any person who wishes to carry on the activities of an InvIT would have to obtain registration from SEBI
Minimum Issue Size	INR 250 crore	INR 250 crore
Minimum subscription size	INR 2 lakh	INR 10 lakh
Listing	After the IPO it shall be mandatory for all units of REITs to be listed on a recognized stock exchange having nationwide trading terminals within a period of 12 working days from the date of closure of the offer.	After the IPO it shall be mandatory for all units of InvITs, whether publicly issued or privately placed, to be listed on a recognized stock exchange having nationwide trading terminals. The units of InvITs have to be listed on the designated stock exchange within <ul style="list-style-type: none"><li>- 30 working days for privately placed units of InvITs</li><li>- 12 working days for publicly offered units of InvITs.</li></ul>

<b>Features</b>	<b>REITs</b>	<b>InvITs</b>
Trading Lot	INR 1 lakh	Privately placed - INR 1 crore Publicly offered – INR 5 lakh
Value of assets owned	The value of assets owned by REITs is required to be at least INR 500 crore.	The value of the assets held by InvIT is required to be at least INR 500 crore.
Investment conditions	<p>a. At least 80% of the value of REIT assets is required to be in completed and rent generating properties.</p> <p>b. Not more than 20% in developmental properties and other eligible investments. Provided, investment in developmental assets is not more than 10% of the value of REIT assets.</p> <p>c. REITs to invest in at least 2 projects with not more than 60% of value of assets invested in one project.</p>	<p>a. At least 80% of the value of InvIT assets is required to be in completed and revenue generating projects.</p> <p>b. Not more than 20% assets shall be invested in under-construction infrastructure projects provided that such investments shall not exceed 10% of the value of InvITs assets.</p>
Net distributable cash flows	REITs are required to distribute not less than 90% of the net distributable cash flows, subject to applicable laws, to its investors.	InvITs are required to distribute at least 90% of the net distributable cash flows, subject to applicable laws, to its investors.
Borrowings	The maximum borrowing permitted is 49% of the value of the REITs assets. If the aggregate borrowings exceed 25% of the value of REITs assets, further borrowing can be done with unit holders approval and credit rating being obtained from a CRA registered with the Board.	The maximum borrowing permitted is 49% of the value of the InvIT assets. If the aggregate borrowings exceed 25% of the value of InvITs assets, further borrowing can be done with unit holders approval and credit rating being obtained from a CRA registered with the Board.