

SEBI's Consultation Paper on MSM REIT

A missed
opportunity?

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1. Responses to General Questions (a) and (b)

(a) *Whether to bring persons /entities (including FOPs) organizing or undertaking or facilitating fractional real estate investments under regulatory perimeter?*

(b) *If so, whether MSM REIT and schemes thereunder as outlined above are appropriate?*

- 1.1. We welcome SEBI's consultation paper titled "Regulatory Framework for Micro, Small and Medium REITs"¹ (hereinafter 'paper') as an important step towards regulating fractional ownership of real estate in India. As the paper notes, the recent increase in the number of Fractional Ownership Platforms (FOPs), coupled with the heterogeneity of their structures and offerings, necessitates regulatory intervention for purposes of investor protection.²
- 1.2. The 'mushrooming'³ of web based FOPs over the last few years has been driven by a larger trend towards asset tokenisation, which in turn gathered momentum due to the growing adoption of blockchain and distributed ledger technologies (DLTs). Generally put, 'asset tokenisation' refers to the creation of digital tokens which represent interests in an underlying asset. These tokens may be understood as digital twins of such assets which can be stored 'on-chain'. Any kind of interest - including those in securities (shares, bond, debentures, derivatives), commodities (gold, silver, oil etc.), tangible assets (real estate, vehicles etc.) or intangible assets (intellectual property, contracts etc.) - can in principle be tokenised. Multiple persons can 'co-own' tokenised assets through contractual distributions of the underlying proprietary interests. This implies that 'fractional ownership' in real estate must not be understood in isolation from the broader trend towards 'asset tokenisation'.
- 1.3. The application of DLTs and smart contracts for asset tokenisation introduces efficiencies in the form of automation, transparency, digitisation, disintermediation and faster clearing and settlement. It also creates liquidity in otherwise illiquid markets, thereby lowering barriers to investment in non-

¹ SEBI 2023, "Regulatory Framework for Micro, Small and Medium REITs (MSM REITs)", Consultation Paper (DDHS - POD 2).

² SEBI 2023, para 2.4.

³ SEI 2023, para 2.1

divisive asset classes such as real estate. This is important to underscore considering that the primary motivation of the paper is to extend the REIT framework to ‘micro, small and medium’ investor classes.

1.4. Presently, there seems to be no global consensus on the manner and form of regulating tokenised assets. Legal characteristics of such tokens also vary depending on the underlying asset and the jurisdiction in question. The OECD,⁴ in a comprehensive report on the subject, highlighted two important policy considerations for regulators:⁵

a. *Substance over form*: Asset tokenisation should be regulated considering the substance of the token or structure and not the form of the token. This approach ensures that if a particular asset token has the characteristics of a recognised instrument, e.g. security, the token should be regulated accordingly.

b. *Technology neutrality*: Regulations should follow a technology agnostic approach which does not discriminate between different technologies being used in a particular product or service.

1.5. Given the above context, it is not surprising that many jurisdictions have approached fractional ownership of real estate under the broader issue of regulation of tokenised assets and security tokens. The table below provides a snapshot of few noteworthy approaches:

⁴OECD stands for the Organisation for Economic Co-operation and Development. It is an international organization that works to shape policies that foster prosperity, equality, opportunity and well-being for all¹. The OECD's opinion on digital markets is important because it provides policy makers with new tools to understand the digital transformation and develop appropriate policies to help shape a positive digital future². The OECD's Digital Economy Outlook examines trends and analyses emerging opportunities and challenges in digital markets³. Its work on digital markets aims to reduce risks and increase trust without inhibiting the opportunities offered by the digital economy⁴. [Source: Conversation with Bing, 26/5/2023(1) Digital - OECD. <https://www.oecd.org/digital/> Accessed 26/5/2023.(2) Digital Economy, Innovation and Competition - OECD. <https://www.oecd.org/daf/competition/digital-economy-innovation-and-competition.htm> Accessed 26/5/2023.(3) The Evolving Concept of Market Power in the Digital Economy – OECD.

<https://one.oecd.org/document/DAF/COMP/WD%282022%2934/en/pdf> Accessed 26/5/2023. Ex-Ante Regulation and Competition in Digital Markets Note by BEUC - OECD.

<https://one.oecd.org/document/DAF/COMP/WD%282021%2966/En/pdf> Accessed 26/5/2023.]

⁵OECD 2021, “Regulatory Approaches to the Tokenisation of Assets, OECD Blockchain Policy Series”, [Regulatory Approaches to the Tokenisation of Assets - OECD](#).

| Sr. No. | Jurisdiction | Approach | Highlights |
|---------|----------------|--|--|
| a) | Germany | Separate legislation titled 'Electronic Securities Act'. | Specifically covers blockchain based security tokens and allows crypto securities registry. ⁶ |
| b) | Japan | Clear framework for security tokens under the Financial Instruments and Exchange Act. | Security Token Offerings (STOs) classified as Type 1 (high liquidity) and Type 2 (low liquidity). ⁷ |
| c) | United Kingdom | English common law covers digital securities, therefore no statutory intervention necessary. | Blockchain based security tokens recognised as digital bearer forms, and treated similar to traditional bearer forms. ⁸ |
| 4 | Switzerland | Licensing system permitting operation of digital exchanges. ⁹ | Blockchain based security tokens can be listed after FINMA approval and subject to compliance requirements. |
| 5 | Hong Kong | Real estate tokenisation as a recognised CBDC use-case. | Pilot program with Ripple ongoing. ¹⁰ |
| 6 | Singapore | Licensing regime for private exchanges dealing in digital tokens. ¹¹ | Exchanges required to comply with provisions of Securities and Futures Act, Financial Advisers Act and the Payment Services Act. ¹² |

⁶ BaFin 2021, [Expert Articles - Now also in electronic form: securities](#).

⁷ Financial Instruments and Exchange Act, Article 2 (para 1).

⁸ UKJT Legal Statement on Digital Securities ([lawtechuk.io](#)), paras 26 – 31, 67 – 70, 80 and 139 – 143.

⁹ Documents - SDX Terms & Conditions | EDSX - European Digital Assets Exchange

¹⁰ Ripple Press Release 2013, [Ripple and Fubon Bank to Showcase Real Estate Asset Tokenization Use Case as part of the Hong Kong Monetary Authority's Inaugural e-HKD Pilot Programme | Ripple](#)

¹¹ Kentaro Iwamoto 2021, [Singapore emerges as Asia's digital securities trading hub - Nikkei Asia](#).

¹² Monetary Authority of Singapore 2020, "A Guide to Digital Token Offerings", sections 1.2 and 1.3.

- 1.6. In 2014, SEBI introduced a comprehensive regulatory framework for REITs in the form of the Real Estate Investment Trusts Regulations, 2014 (“REIT Regulations”). These were broadly aligned with global frameworks at the time, pertaining to distribution of dividends, segregation of roles and responsibilities between sponsor and manager, requirements relating to listing as well as minimum net worth of the stakeholders. They were initially welcomed by the real estate industry for providing new avenues of raising capital as well as by institutional and retail investors for introducing a new instrument to gain exposure to high-end commercial real estate.
- 1.7. However, as the paper itself notes, the REIT framework has not been able to gain sufficient traction within the real estate investment market. If we consider the number and frequency of REIT listings to be an indicator of its popularity, the numbers are far from encouraging. The first REIT was listed after five years of the introduction of the REIT framework. And today, after nine years, merely 5 REITs have been registered with SEBI of which only 3 REITs have issued units which are actually listed on stock exchanges.¹³
- 1.8. Arguably, the 2014 framework failed to attract investors because of cumbersome disclosure and reporting requirements. These pertain to pre and post issuance as well as listing of REIT units, and also include detailed provisions on eligibility, minimum net worth and other criteria/operational requirements for the sponsor and manager in order to protect investors. In retrospect, it seems clear that despite being well intentioned these provisions acted as a significant entry barrier.
- 1.9. In view of the foregoing, our respective responses to questions (a) and (b) are as follows:
- a. FOPs must be brought within the regulatory perimeter in order to ensure that the entry barrier for smaller investors is reduced, and that their interests are duly protected.
 - b. However, the manner and scope of the regulations envisaged under the consultation paper are inadequate for three interconnected reasons.

¹³ Para 3.5 of the Consultation Paper on Regulatory Framework for Micro, small & medium REITs (MSM REITs) released by SEBI in May, 2023.

- i. First, the proposed framework must be seen as a missed opportunity by SEBI to introduce a broader framework pertaining to asset tokenisation. As highlighted in para 1.5, many advanced jurisdictions have taken the rise in FOPs as an opportunity to clarify their regulatory stance on asset tokenisation as well as digital securitisation generally. Admittedly, there is considerable divergence in their approaches, with some (e.g. Germany) opting for a separate framework for digital securities and others (e.g. Switzerland) opting for a license-based system for digital exchanges.¹⁴ Nonetheless, what is common to these approaches is a clear identification that blockchain based asset tokenisation requires a clear regulatory framework in its own right.
- ii. Second, the proposed framework does not put the rise of FOPs in its proper historical context and thereby assumes that ‘fractional ownership’ is an issue which is unique to the real estate sector. As discussed in para 1.2 above, blockchain and DLT technologies enable any asset to be ‘tokenised’ and fractionally owned. This implies that the benefits of fractionalisation are already being extended to assets beyond the real estate sector, a phenomenon which will invariably require broader regulation in the future.
- iii. Third, instead of taking the rise of FOPs as an instance to re-examine a regulatory framework which has proved ineffective, viz. the 2014 REIT regulations, the paper seeks to preserve and update it through a separate chapter on MSM REITs. While the broad purposes for doing so are laudable, the paper ignores that such opportunities and challenges are present in other sectors as well. A general consultation paper on a suggested framework for FOPs may therefore have been more valuable. Such an approach would have allowed regulators and investors alike to benefit from the efficiency gains of blockchain (refer 1.3) and adapt



¹⁴In another notable instance, the US Securities and Exchange Commission recently granted a special purpose broker license to Prometheus Capital, allowing it to deal in blockchain based securities. [Prometheus Ember Capital is the First SEC Qualified Custodian for Digital Assets Securities | Business Wire](#).

them to sector specific needs. Even within the real estate sector, the paper could have benefited from a more wholistic view on related policy developments. The Niti Aayog has suggested the use of blockchain based registries for land records.¹⁵ Several states have already acted on this advice and are using blockchain for property registration.¹⁶ It is therefore both possible and advisable for FOPs to be beneficially integrated with such registries, allowing small investors to get access to the commercial real estate sector in a reliable and transparent manner. Our hope is that in the near future regulators will consider the benefits of such an integrative policy approach.



¹⁵Niti Aayog 2020, “Blockchain: The India Strategy, Part 1”. [Blockchain The India Strategy Part I \(niti.gov.in\)](https://www.niti.gov.in/blockchain-the-india-strategy-part-1), pg 31.

¹⁶ See, for instance the Karnataka example: [Karnataka to use blockchain for property registration | Deccan Herald](https://www.deccanherald.com/karnataka-to-use-blockchain-for-property-registration).

2. Response to Specific Questions (c) - (I)

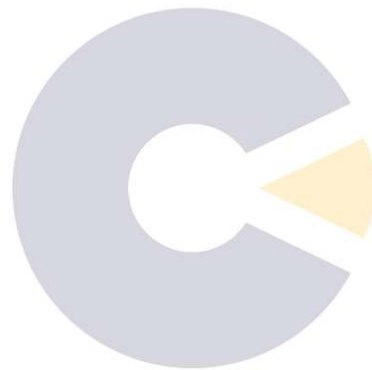
| Sr. No | Issues | Suggestions | Rationale |
|--------|---|---|---|
| 1. | Question (c): <i>Whether the time period for existing Persons/Entities (including) FOPs with SPVs to migrate to MSM REIT within six months is sufficient?</i> | A grace period of nine months should be provided to the existing entities or the period of six months should exclude any time taken by the Board in adjudicating the registration applications. | MSM REIT framework requires existing entities to apply and obtain registration under the new framework. Currently, it is not clear whether the regulation will provide any time limit within which SEBI will decide on the application of a particular registrant. It is possible that the registration process may take a few months even after the application has been submitted. Secondly, the common structures currently used by the existing entities are substantially different from the one proposed under the new framework. |
| 2. | Question 9(d): <i>Whether net worth of Sponsor of INR 20 crores is adequate?</i> | Yes. In fact, the minimum net worth of each sponsor may be further reduced to INR 10 crores in case of MSM REIT. | The minimum offer size and cap on consolidated value of assets which can be managed under MSM REIT is much lower than general REITs. The prescribed net worth of each Sponsor for a general REIT is INR 20 crores and, therefore, for the MSM REITs the same can be reduced to INR 10 crores. Since the sponsor is required to hold a minimum of 15% of the total units for at least three years, this may be considered adequate to ensure compliant behaviour. |
| 3. | Question 9(e): <i>Whether relevant experience of Sponsor outlined above is sufficient?</i> | Yes. | REIT Regulations require the Sponsor to have a minimum of five years of experience in development of real estate or fund management in the real estate industry. Considering |

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| | | | the smaller size and amount involved in the MSM REIT, the minimum experience requirement should be kept at three years. |
| 4. | Question 9(g): <i>Whether net worth of Manager of INR 10 crores is adequate?</i> | Yes. The prescribed net worth of Manager may be further reduced to INR 5 crores. | The minimum offer size and cap on consolidated value of assets which can be managed under MSM REIT is much lower than general REITs. The prescribed net worth of a Manager for general REIT is INR 10 crores which can be reduced to INR 5 crores in case of MSM REITs. |
| 5. | Question 9(h): <i>Whether the cap on Consolidated value of MSM REIT to INR 500 crores or scheme should be capped at INR 250 crores or INR 500 crores?</i> | The consolidated value of MSM REIT may be capped at INR 500 crores. | Under the 2014 REIT regulations, an initial offer can be made if the value of real estate assets is INR 500 crores or above. Therefore, the consolidated value of MSM REIT can be capped at INR 500 crores such that there is greater consistency between the two frameworks. |
| 6. | Question 9(i): <i>Whether minimum subscription should be mandated to INR ten lakhs?</i> | No. The minimum subscription should be INR one lakh. | To further reduce the entry barrier and maximise the benefits of fractional ownership for small investors, the minimum subscription amount should not be very high. Keeping the minimum subscription mandate to INR ten lakhs would go against the intended purpose of providing access to the REIT regime to retail investors. |
| 7. | Question 9(j): <i>Whether trading lot should be kept as minimum value of INR ten lakhs?</i> | No. It should be kept at a minimum value of INR one lakh. | Same as above. |
| 8. | Question 9(l): <i>Whether the Sponsor and Investment Manager should be two distinct</i> | One entity should be allowed to function as both Sponsor and Investment manager. | Considering the high value of investment and the time and effort required to manage a large number of properties, |

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| | <p><i>entities, or Whether only one entity (i.e. the Investment Manager) can take up the roles and responsibilities of both the Sponsor as well as Investment Manager? Kindly provide your comments with supporting rationale.</i></p> | | <p>the REIT Regulations 2014 provide for two independent and separate entities, i.e. Sponsor and Manager. MSM REITs are likely to involve a smaller number and value of properties. Therefore, merging the roles and responsibilities of both the entities will reduce administrative and compliance costs.</p> |
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