FDI IN REAL ESTATE IN INDIA: LAW, POLICY AND PRACTICE

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ABSTRACT

The Indian real estate sector is among the fastest growing in the world, and one of the most critical sectors for the Indian economy. Recent reports indicate that the sector has begun to generate an increased interest amongst foreign investors. However, from a foreign investment perspective, real estate has historically been one the most jealously guarded sectors, with FEMA regulations and successive FDI Policies establishing an intricate set of controls that heavily regulate the entry of foreign capital into Indian real estate. To illustrate this point, it would be apposite to note that in precise legal terms, "FDI in real estate" is itself a misnomer, since, as prescribed in the Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000, and each Consolidated FDI Policy of India, "real estate business" is one of the prohibited sectors with respect to FDI. Further, other FEMA Regulations such as the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2000 impose several controls and procedural requirements for the acquisition and transfer of immovable property in India even by NRIs and Persons of Indian Origin. That being said, foreign investment in real estate has come to be equated with investment in the "construction development sector," which was thrown open to foreign investment in 2005. Recent policy changes introduced by the Government of India, aimed at increasing the ease of doing business for investors, are poised to inject fresh foreign capital into the sector. This, coupled with the introduction of Real Estate Investment Trusts ('REITs'), has combined to create a positive and compelling investment atmosphere in the real estate sector. Accordingly, the purpose of the

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present article is to clarify the exact scope and contours of FDI in the Indian real estate sector, with reference to the extant legal regime, government and FIPB policy, the recently introduced changes to law and policy, and certain outstanding legal issues.

I. INTRODUCTION

The Indian real estate sector is one of the most critical and fastest growing sectors of the Indian economy. The size of the Indian real estate market was estimated to be approximately $78.5 billion in FY13 and is expected to grow to approximately $140 billion in FY17.[1] Since it has many stakeholders and is inter-connected with a number of different sectors, growth in the real estate sector has a huge multiplier effect on the economy and is therefore a major driver of economic growth. Not only does it generate a high level of direct employment, but it also stimulates demand in over 250 ancillary industries such as cement, steel, paint, brick, building material, consumer durables and so on. As per recent estimates, its contribution to India's GDP has been 5-6%. [2]

As one of the critical sectors of the economy, the real estate sector requires constant infusion of a large amount of capital, including, in the interests of the sector, foreign investment. However, the real estate sector *per se* is subject to heavy foreign investment regulation under the Foreign

1 Ernst & Young and FICCI, *Brave new world for India real estate: Policies and trends that are altering Indian real estate*, available at: <http://www.ey.com/Publication/vwLUAssets/EY-Brave-new-world-for-India-real-estate/$FILE/EY-Brave-new-world-for-India-real-estate.pdf> (accessed 2nd April 2015).

2 See generally, < http://www.ficci.com/sector/59/Project_docs/real-eastate-profile.pdf> (accessed 2nd April 2015).

Exchange Management Act, 1999 ('FEMA') regime, read with the extant Foreign Direct Investment ('FDI') Policy and other relevant regulations, notifications and guidelines. The sector has witnessed manifold changes in recent times in terms of easing of conditions for foreign investment and introduction of Real Estate Investment Trusts ('REITs'). The present article, therefore, is an attempt to examine the law, policy and practice with respect to FDI in the Indian real estate sector. Part II will clarify the exact scope of "FDI in real estate" in India with reference to the extant legal regime. It is concluded that while FDI in the "real estate business", *viz.* dealing in land for profit is prohibited, real estate in terms of construction and built-up infrastructure is open to 100% foreign investment under the automatic route. Accordingly, Part III will examine the extant norms for FDI in the construction development sector through a comparative table. Thereafter, Part IV will examine the scope of foreign investment in real estate in terms of REITs, in light of the newly introduced Securities and Exchange Board of India (Real Estate Investment Trust) Regulations, 2014, including a discussion on potentially contentious issues. Finally, Part V will offer a brief concluding analysis.

II. Clarifying the scope of "FDI in real estate in India"

Any involvement of foreign investment in the real estate sector leads to host of restrictions under FEMA. Real estate has traditionally been a prohibited sector for foreign investment.[3] As per the 2014 FDI Policy,[4] "real

[3] See, FEMA Notification No. 1/2000-RB dated May 3, 2000 ['FEMA 1'], available at: < http://rbi.org.in/scripts/BS_FemaNotifications.aspx?Id=155> (accessed 1st April 2015). In fact,

estate business or construction of farm houses" is a "prohibited sector"[5] with respect to FDI. However, the ambit of the term "real estate business" cannot be ascertained under this Policy, since it is not defined therein. It is also notable that the term was not defined in the 2013,[6] 2012[7] or 2011[8] FDI Policies. However, a definition can be located in the 2010 FDI Policy,[9] albeit within parentheses, and in an otherwise unrelated sub-Paragraph dealing with the eligibility of resident entities for NRI/PIO investments,[10] which defines real estate business as "dealing in land and immovable property with a view to earning profit or income therefrom." It is notable that after this gap of 4 years, the definition of "real estate business" has been accorded a more

the overarching policy of the Government of India has been to limit dealings in Indian land. For instance, the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2000 ['FEMA 21'] impose several controls and procedural requirements for the acquisition and transfer of immovable property in India by NRIs/PIOs. See, FEMA 21, available at: <https://rbi.org.in/Scripts/BS_FemaNotifications.aspx?Id=175> (accessed 25th June 2015).

4 Consolidated FDI Policy Circular of 2014 (Department of Industrial Policy and Promotion ('DIPP'), Ministry of Commerce & Industry, Govt. of India, 17th April 2014), available at: <http://dipp.gov.in/English/Policies/FDI_Circular_2014.pdf> (accessed 2nd April 2015) ['2014 FDI Policy'].

5 Paragraph 6.1(f), 2014 FDI Policy.

6 Consolidated FDI Policy of India, vide Circular 1 of 2013 (DIPP, Ministry of Commerce & Industry, Govt. of India, 5th April 2013), as available at: <http://dipp.nic.in/English/Policies/FDI_Circular_01_2013.pdf> (accessed 1st April 2015).

7 Consolidated FDI Policy of India, vide Circular 1 of 2012 (DIPP, Ministry of Commerce & Industry, Govt. of India, 10th April 2012), as available at: <http://dipp.nic.in/English/Policies/FDI_Circular_01_2012.pdf> (accessed 2nd April 2015).

8 Consolidated FDI Policy of India, vide Circular 2 of 2011 (DIPP, Ministry of Commerce & Industry, Govt. of India, 1st October 2011), as available at:< http://dipp.nic.in/English/policies/FDI_Circular_02_2011.pdf> (accessed 2nd April 2015).

9 Consolidated FDI Policy of India, vide Circular 1 of 2010 (DIPP, Ministry of Commerce & Industry, Govt. of India, 1st April 2010), available at <http://www.oifc.in/Uploads/MediaTypes/Documents/FDI_CIRCULAR_1_OF_2010_CONSOLIDATED_FDI_POLICY.pdf> (accessed 2nd April 2015) ['2010 FDI Policy'].

10 Paragraph 3.3.2(iv), 2010 FDI Policy.

prominent place in the 2015 FDI Policy,[11] and occurs in the clarifications issued under the construction development sector.[12]

The above definition has been reproduced from FEMA Notification No. 1/2000-RB dated May 3, 2000 ['FEMA 1'][13] read with the RBI Master Circular on Foreign Investment,[14] which, while defining real estate business to include dealing in land and immovable property with a profit motive, *excludes* from its scope *development of townships, construction of residential/commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure and townships.* Therefore, while real estate in terms of dealing in land has traditionally remained off-limits for FDI, certain other sectors dealing with built-up infrastructure have been distinguished and excluded from the ambit of "real estate business". These sectors were opened up to foreign investment by the path-breaking DIPP Press Note 2 of 2005 [PN 2].[15]

PN2 permitted 100% FDI under the automatic route in townships, housing, built-up infrastructure and construction-development projects (which would include, but not be restricted to, housing, commercial

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11 Consolidated FDI Policy Circular of 2015 (DIPP, Ministry of Commerce & Industry, Govt. of India, 12th May 2015), available at: < http://dipp.nic.in/English/policies/FDI_Circular_2015.pdf> (accessed 25th June 2015) ['2015 FDI Policy'].

12 Note (i), Paragraph 6.2.11.2, 2015 FDI Policy.

13 *Supra* note 3.

14 Reserve Bank of India, *Master Circular on Foreign Investment in India,* available at: <http://www.rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=9006> (accessed 2nd April 2015).

15 Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, Press Note 2 of 2005, available at: < http://dipp.nic.in/English/policy/changes/pn2_2005.pdf> (accessed 2nd April 2015).

premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure) subject to fulfilment of certain entity level and project level requirements.

In consonance with the above, the present position with respect to FDI in the real estate sector as outlined in the extant FDI Policy is that, while FDI is still prohibited in the "real estate business", i.e. dealing in land and immovable property with a profit motive, 100% FDI through the automatic route is permitted in the "Construction Development" sector (comprising townships, housing and built-up infrastructure, the ambit of which is identical to that outlined by PN2, as provided above). In spirit, FDI in the broad sphere of real estate is permissible only if it is used for developmental purposes, and not for buying and selling of land.

III. Conditions to be fulfilled for FDI in the construction development sector

While the construction development sector allows 100% FDI through the automatic route, the FDI Policy imposes several conditions pertaining to how foreign investment is to be made. The conditions prescribed by the 2014 FDI Policy mirror those that were introduced under PN2.[16] However, since then, the government – ostensibly in its drive to increase the ease of doing business in India – has systematically liberalized the FDI regime both on the whole, and particularly with respect to the construction development sector. In respect of the latter, this liberalization

[16] The salient features of PN2 have been discussed *infra* in Table I.

occurred in two phases: in October 2014 and thereafter, more recently in November 2015.

On October 29, 2014, the Union Cabinet issued a press release titled *Review of FDI in the Construction Development Sector,*[17] outlining several proposed amendments to the conditions in force, aimed at easing the FDI norms. These amendments were notified *vide* DIPP Press Note No. 10 of 2014 ['PN10'],[18] and formed the basis of Paragraph 6.2.11 (which pertains to the construction development sector) of the 2015 FDI Policy.[19]

However, on November 10, 2015, barely six months from the notification of the FDI Policy, the government announced sweeping changes to the existing FDI regime, covering numerous sectors including construction development.[20] These amendments have been notified *vide* DIPP Press Note 12 of 2015 ['PN12'],[21] and the entire Para 6.2.11 has been replaced, incorporating several changes – both insertions and deletions – to the earlier position.

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17 Press Information Bureau, Government of India, *Review of Foreign Direct Investment policy on the Construction Development Sector*, 29th October 2014, available at: <http://pib.nic.in/newsite/PrintRelease.aspx?relid=110938> (accessed 2nd April 2015).

18 Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, Press Note 10 of 2014, available at: < http://dipp.nic.in/English/acts_rules/Press_Notes/pn10_2014.pdf> (accessed 2nd April 2015).

19 *Supra* note 11.

20 See, *Govt. eases FDI norms in 15 major sectors*, Indian Express (11th November 2015), available at: <http://indianexpress.com/article/india/india-news-india/govt-eases-fdi-norms-fipb-limit-raised-from-rs-3000-crore-to-rs-5000-crore/> (accessed 27th January 2016)

21 Department of Industrial Policy and Promotion, Ministry of Commerce and Industry, Government of India, Press Note 12 of 2015, available at: < http://dipp.nic.in/English/acts_rules/Press_Notes/pn12_2015.pdf> (accessed 25th January 2016).

The purpose of this Part is to track and discuss the above developments in detail, in order make the present position with respect to FDI in the construction development sector crystal clear. To this end, Sub-Part A will discuss, in the form of a comparative table with explanatory comments (Table I), the original conditions as prescribed under PN2/2014 FDI Policy and the revised conditions as prescribed by PN10/2015 FDI Policy. Sub-Part B will elaborate upon and analyze the changes wrought by PN12 to reflect the latest position.

VI. TABLE I: POSITION UNDER PN2/FDI POLICY 2014 AND CHANGES INTRODUCED BY PN10/FDI POLICY 2015

S. No.	CONDITION	PN2/FDI POLICY 2014	PN10/FDI POLICY 2015	COMMENTS
1	Minimum area to be developed	a) For serviced housing plots, minimum land area of 10 hectares. b) For construction development projects, minimum built-up area of 50,000 sq. metres. c) In case of a combination project, either of the above 2 conditions should be fulfilled.	a) No minimum land area requirement in case of *serviced* plots. b) For construction development projects, minimum *floor area*[22] of *20,000* sq. metres.	(i) The replacement of "serviced housing plots" with "serviced plots" indicates that companies are now allowed to develop commercial plots.
2	Minimum capitalization	A company seeking foreign investment for construction development projects must be capitalized to a certain extent (USD 10 million for wholly owned subsidiaries and USD 5 million for joint ventures with Indian partners) by the foreign investor. Also, such capitalization should be brought in within 6	The investee company is now required to bring a *reduced minimum* of USD 5 million of FDI within 6 months of the commencement of the project (fixed as the date of approval of the building/layout plan by the relevant authority).	

[22] As per Note (v) of PN10, 'Floor area' will be determined as per the local laws/regulations of the concerned State Government or Union Territory. Further, the Indian investee company is required to procure a certificate from an architect empanelled by any Authority to the effect that the minimum floor area requirement has been met.

		months of commencement of business of the company.	Subsequent tranches of FDI can be brought till 10 years from the commencement of the project or before the completion of the project, whichever expires earlier.	
3	Lock-in /investor exit	a) Original investment was not permitted to be repatriated before a period of three years from the date of completion of minimum capitalization. b) If the foreign investor sought to make an early exit, it was required to obtain prior approval of the FIPB.	a) The investor is now permitted to exit either on completion of the project,[23] or after development of trunk infrastructure (defined as roads, water supply, street lighting, drainage and sewerage).[24] b) The FIPB shall consider, on a case-to-case basis, proposals for repatriation of FDI or transfer of stake from one non-resident investor to another.	It has been specifically clarified by the DIPP that investor exit will be considered on a case-to-case basis by the FIPB even before completion of the project or development of trunk infrastructure.[25]
4	Investor Obligations	a) It was earlier required that at least 50% of the project must be developed within a period of 5 years from the date of obtaining all statutory clearances. b) It was further prescribed that the investor/ investee company was not permitted to sell undeveloped plots and was required to obtain a completion certificate from the concerned local body/service agency before being allowed to dispose of serviced housing plots. c) The investor/investee company was responsible for obtaining all the requisite regulatory	a) This requirement has been deleted. b) It has been clarified that the Indian investee company will be permitted to sell only *developed* plots (defined as plots where trunk infrastructure, i.e. roads, water supply, street lighting, drainage and sewerage, has been made available). c) This requirement, too, has been deleted in terms of the investor; it is now the Indian investee company that is responsible	

[23] As per Note (vi) of PN10, completion of the project is to be determined as per the local bye-laws/rules and other regulations of State Governments.

[24] The completion of trunk infrastructure should be certified by an architect registered with the Council of Architecture. See, Sl. No. 6 in Department of Industrial Policy and Promotion, *Clarification on Press Note 10 of 2014*, available at: <http://dipp.nic.in/English/acts_rules/Press_Notes/Clarification_PressNote10_2014.pdf> (accessed 3rd April 2015).

[25] See, Sl. No. 3 in Department of Industrial Policy and Promotion, *Clarification on Press Note 10 of 2014*, available at: < http://dipp.nic.in/English/acts_rules/Press_Notes/Clarification_PressNote10_2014.pdf> (accessed 3rd April 2015).

		permission.	for obtaining regulatory clearance.	
5	Local Require-ments	a) The project should conform to the norms and standards, including land use requirements and provision of community amenities and common facilities, as laid down in the applicable building control regulations, bye-laws, rules, and other regulations of the State Government/ Municipal/Local Body concerned. b) State Government/Municipal/ Local Body concerned would monitor the project to ensure compliance with the above conditions.	These requirements have been retained verbatim.	
6	Completed projects	–	100% FDI under the automatic route is allowed for operation and management of townships, malls/shopping complexes and business centres.[26]	
7	Affordable housing	–	No condition in respect of minimum area to be developed and minimum capitalization shall apply to an investee/ joint venture company which commits at least 30% of the total project cost for low cost affordable housing.	

VII. Latest, Liberalized Position: PN12 of 2015

As stated above, the government recently liberalized several sectors to attract and facilitate foreign investment, and the same have been codified by PN12. Paragraph 21 of PN12 pertains to the construction development sector, and introduces a new Para 6.2.11 of the FDI Policy. The following is a brief analysis of the pertinent changes made in respect of the conditions to

[26] "Business centre" includes where multiplicity of businesses of same or different nature are being carried out from a particular building. See, Sl. No. 9, *ibid.*

be fulfilled for FDI in the construction development sector.

2. Minimum floor area and minimum capitalization requirements deleted

One of the most notable changes brought in by PN12 is the deletion of *all* requirements pertaining to minimum floor area (20,000 sq. metres) and minimum capitalization (of $5 million) under PN10/2015 FDI Policy.[27] As one commentator notes, the earlier conditions – with the minimum floor area and capitalization requirements – tended to favour construction activity only in Tier-I cities, since development at this scale was deemed unviable in smaller cities.[28] Thus, the removal of these requirements would provide a fillip to construction development in Tier-II and Tier-III cities. This certainly appears to be a welcome change, since it is poised not only to invite a larger volume of investment, but also to ensure that the benefits of increased investment are distributed in a more equitable manner.

3. Phases to be considered separate projects

In an interesting insertion, the new Para 6.2.11.2 specifies that "Each phase of the construction development would be considered as a separate project for the purpose of FDI policy."[29] Given that there is no further qualification to this statement, the question that arises is: what constitutes a "phase" of construction development? No doubt the segregation of each

[27] All allied conditions pertaining to minimum floor area and capitalization under PN10/2015 FDI Policy have also been deleted, such as those relating to definition of floor area, certification of minimum floor area by an architect, etc.

[28] Kalpesh Maroo, *New FDI norms: Real gains for real-estate sector,* THE FINANCIAL EXPRESS (16th November 2015), available at: < http://www.financialexpress.com/article/fe-columnist/column-new-fdi-norms-real-gain-for-real-estate-sector/166038/> (accessed 27th January 2016).

[29] Paragraph 6.2.11.2, DIPP Press Note 12 of 2015, *supra* note 21 at p. 12.

phase for FDI purposes implies that all investment conditions must be met at each phase, but it is puzzling that "phase" itself has not been defined. It is hoped that the meaning of this term will be provided in the text of the upcoming 2016 FDI Policy, which will provide much-needed clarity to investors.

4. *Lock-in/Investor exit: regime overhaul*

The earlier conditions prescribed that the investor shall be permitted to exit either on completion of the project, or after the development of trunk infrastructure. It was additionally provided that the FIPB would consider proposals for repatriation of FDI or transfer of stake from one non-resident investor to another on a case-to-case basis.

These conditions have undergone a complete overhaul under PN12. The first, general condition – that the investor shall be permitted to exit either on completion of the project or after the development of trunk infrastructure – has been retained [as Paragraph 6.2.11.2(A)(i), hereinafter referred to as "Para (A)(i)"]. However, a new set of conditions has been introduced thereafter *vide* Paragraph 6.2.11.2(A)(ii) [hereinafter referred to as "Para (A)(ii)"], the text of which is reproduced as follows:-

> *Notwithstanding anything contained at (A)(i) above, a foreign investor will be permitted to exit and repatriate foreign investment before the completion of the project under automatic route, provided that a lock-in period of three years, calculated with reference to each tranche of foreign*

> *investment has been completed. Further, transfer of stake from one non-resident to another non-resident, without repatriation of investment will neither be subject to any lock-in period nor any government approval.*[30]

There are two key takeaways from this insertion. *First,* notwithstanding the prescriptions of Para (A)(i), a lock-in period of 3 years with respect to each tranche of investment has been introduced. Once the lock-in period has been completed, the investor is permitted to exit the project, even if it is not complete, without the requirement of government approval. *Secondly,* the earlier restrictions on transfer of stake between non-residents have been done away with: it is now provided that such transfers (so long as the investment is not repatriated) are not subject to any lock-in, and do not require government/FIPB approval.

While the second change with respect to transfer of stake is fairly straightforward, the first condition pertaining to investor exit merits a closer look. Under the earlier requirements (ignoring the possibility of a government-approved exit), the minimum that an investor was bound to do before his exit was develop trunk infrastructure. PN12, however, operates slightly differently in that it lessens investor obligations with respect to development of basic infrastructure prior to an exit. A conjoint reading of Paras (A)(i) and (A)(ii) makes the following position clear: an investor can now exit upon the completion of the project or development of trunk infrastructure; or, due to the presence of the non-obstante clause in Para

[30] Paragraph 6.2.11.2 (A)(ii), Press Note 12 of 2015, *supra* note 21 at p. 12.

(A)(ii), he can straightaway exit before the completion of the project so long as the investment has been locked in for 3 years.

It must be noted that completing a 3 year lock-in does not guarantee the completion of trunk infrastructure. Thus, the very introduction of the lock-in linked exit option before completion of the project means that the new, lower minimum that an investor has to do before his exit is merely complete the lock-in period, whether or not he completes trunk infrastructure during that time. Therefore, the changes brought in by PN12 essentially signal a win-win for the investor: he is not only permitted to exit before completion of the lock-in if the trunk infrastructure (or the project itself) is completed, but also to leave before even completing trunk infrastructure, so long as he has served out the lock-in period.

In sum, the revised conditions under PN12 have diluted the investor obligations as to development of trunk infrastructure: he may now exit without bringing any tangible benefit to domestic infrastructure, simply by serving out a lock-in period. In its zeal to increase the ease of doing business, the government has gone beyond "striking a balance" between domestic interest and ease of investment: the scales are clearly tilted in favour of investor convenience. Therefore, it is hoped that the government introduces certain minimum development obligations for investors even within the lock-in period, so that domestic infrastructure is assured at least some gains from foreign investment.

5. *Clarification to definition of "real estate business"*

An important clarification that the government has issued in PN12 is

that the earning of rent/income on lease of property – so long as it does not amount to transfer[31] – does not fall within the ambit of "real estate business",[32] and is accordingly open to FDI. This clarification appears to permit foreign investment in completed buildings/assets, so long as the intention is simply to lease them out for the purposes of rental income, and not to buy and sell. This clarifies a long-persisting ambiguity in the policy with respect to FDI in completed assets, and is a welcome move, since it will allow large Indian developers the flexibility to sell their portfolio of developed assets and deleverage their balance sheets.[33] Additionally, it will benefit several operating companies with large real-estate holdings to monetize their non-core real estate holdings.[34]

6. Completed projects: additional provisions

As per the earlier position, 100% FDI was allowed in completed projects for operation and management of townships, malls/shopping complexes and business centres. PN12 makes certain additional prescriptions in respect of the same. It is now provided that consequent to foreign investment, transfer of ownership and/or control of the investee company from residents to non-residents is permitted; however, such investment would be subject to a lock-in period of 3 years (calculated with reference to each tranche of FDI), and transfer of immovable property is not permitted

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31 For a definition of "transfer" see Note (v), Paragraph 6.2.11 of Press Note 12 of 2015, *supra* note 21 at p. 13.
32 See Note (i), Paragraph 6.2.11 of Press Note 12 of 2015, *supra* note 21 at p. 13.
33 *Supra* note 28.
34 *Ibid.*

during this period.[35] Thus, the government has brought in drastic changes to the regime for FDI in the construction development sector. The overall aim being to liberalize and make the sector more attractive to foreign investors, it is hoped that the issues and grey areas highlighted above are addressed and the requisite changes or clarifications are made.

VIII. REITs: A New Avenue for Foreign Investment in Real Estate SEBI (Real Estate Investment Trust) Regulations, 2014 ['REIT Regulations']

In a welcome move for all the stakeholders in the Indian real estate sector, SEBI notified the REIT Regulations on September 26, 2014. This has been seen by commentators as a major fillip to the sector, which has been a long time coming.[36] If implemented correctly, the REIT regime is expected to attract a huge inflow of investment, both domestic and foreign, into the real estate sector in India.

An REIT is an investment vehicle which owns and/or operates income-producing real estate assets. REITs are usually listed on the stock exchange, and raise funds by issuing units or shares to a pool of investors, which are then utilized to purchase income-producing real estate assets.[37] A

[35] Note (iv), Paragraph 6.2.11 of Press Note 12 of 2015, *supra* note 21 at p. 13.

[36] Prior attempts by the securities regulator to introduce REITs (in 2008) and Real Estate Mutual Funds were abject failures, due to issues pertaining to tax, restrictive investment and asset criteria and certain other conditions. For a draft of the 2008 REIT guidelines that failed to take off, see: < http://www.sebi.gov.in/commreport/RealEstateReg.pdf> (accessed 2nd April 2015).

[37] See, Knight Frank, *Analysis of REIT Regulations,* March 2015, available at: <http://content.knightfrank.com/research/796/documents/en/analysis-of-reit-regulations-2712.pdf> (accessed 3rd April 2015).

sizeable chunk of the earnings from these assets is regularly distributed amongst the REIT's unit-holders as dividends.[38]

REITs were introduced as in the USA in the early 1960s, and now successfully function in over 20 countries, including *inter alia,* the UK, Australia, Singapore, Hong Kong, France and Japan.[39] The long-awaited introduction of the REIT regime in India has the potential to transform the real estate sector. REITs will help to attract long-term financing from domestic as well as foreign sources, which would improve fund availability for real estate developers and reduce some burden on completed assets by allowing owners of such assets to raise capital from investors against issue of units.[40] As per the latest estimates of Cushman & Wakefield, the REIT sector in India has the potential to reach a market capitalization of USD 20 billion by 2020.[41]

The salient features of the regime established by the REIT Regulations are as follows:-[42]

- REITs shall be established as per the provisions of the Indian Trusts Act, 1882, and shall be registered with SEBI. The parties to an REIT shall be the trustee, sponsor(s) and manager.

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38 See generally, < http://www.mondaq.com/india/x/336834/Fund+Management+REITs/REITs+ To +Boost+Growth+And+Transparency+In+Indian+Real+Estate+Sector> (accessed 2nd April 2015).

39 *Ibid.*

40 *Supra* note 37.

41 Supra note 38.

42 See generally, <http://vinodkothari.com/wp-content/uploads/2014/08/A_beginning_for_REITs_in_-India-_-SEBI-_finalises_-REITs_regulations.pdf> (accessed 2nd April 2015).

- The REIT is mandatorily required to be listed.
- At least 80% of the value of REIT assets needs to be in completed and revenue generating properties. The remaining 20% can be invested in: developmental properties (subject to a cap of 10%)
- The investment of an REIT is to be made either directly or through a Special Purpose Vehicle ('SPV') holding at least 80% of its assets directly in such properties; additionally, the REIT shall hold controlling interest and not less than 50% of the equity share capital of such SPV.

The next part shall explore the potential hindrances that foreign investment in REITs face under the current FDI regime.

IX. FDI IN REITS: POTENTIAL HINDRANCES

As discussed above, the REIT regime in general is aimed at attracting investment into the real estate sector, particularly foreign investment. However, despite the introduction of the REIT Regulations, the question of foreign investment in REITs is yet to be resolved. Regulation 14(12) of the REIT Regulations provides that:-

> *The REIT may invite for subscriptions and allot units to any person, whether resident or foreign:*
>
> *Provided that in case of foreign investors, such investment shall be subject to guidelines as may be specified by the Reserve Bank of India*

and the government from time to time.[43]

Currently, however, the guidelines for foreign investment in REITs are awaited.[44] In the interim, it is pertinent to discuss the potential hindrances to foreign investment in REITs under the extant FDI regime.

Foreign investment in an REIT essentially qualifies as foreign investment in a *trust*. As per Paragraph 3.2.4 of the FDI Policy 2014, FDI in trusts other than Venture Capital Fund ('VCF')[45] is not permitted. VCFs are now better referred to as Alternate Investment Funds or "AIFs";[46] however, as prescribed by the FIPB, VCFs should be read as AIFs in the relevant paragraphs of the FDI Policy.[47] Accordingly, with respect to VCF/AIF,

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[43] Regulation 14(12), Securities and Exchange Board of India (Real Estate Investment Trust) Regulations, 2014, available at: < http://www.sebi.gov.in/cms/sebi_data/attachdocs/1411722678653.pdf> (accessed 2nd April 2015).

[44] *Supra* note 25 at p. 9.

[45] "Venture Capital Fund" is defined at Para 2.1.42 of the 2014 FDI Policy as: *a Fund established in the form of a trust, a company including a body corporate and registered under Securities and Exchange Board of India (Venture Capital Fund) Regulations, 1996, which*
(i) has a dedicated pool of capital;
(ii) raised in the manner specified under the Regulations; and
(iii) invests in accordance with the Regulations.

[46] This is following SEBI's replacement of the Venture Capital Fund Regulations, 1996 with the Alternative Investment Fund Regulations, 2012. This development has been noted and resolved by the FIPB in its Review 2011-2013, in the following words: *The extant FDI policy only covers Venture Capital Funds (VCFs) and does not refer to Alternate Investment Funds (AIFs). As per the extant FDI Policy, if a Domestic Venture Capital Fund is set up as a trust, a person resident outside India (non-resident entity/ individual including an NRI) can invest in such domestic VCF subject to approval of the FIPB. However, it has been observed that AIFs have been set up under a separate regulation and the AIF regulations have replaced the VCF regulations. FIPB has deliberated at length on this matter. As such, it is necessary that FDI policy should take specific cognizance of the AIF regulations.* Accordingly, the FIPB has approved investments in AIFs subject to a set of 7 prescribed conditions. See, Foreign Investment Promotion Board, *Review2011-2013,* at pp. 17-18, available at: < http://www.fipb.gov.in/Forms/FIPBREVIEW2011-13.pdf> (accessed 2nd April 2015).

[47] *Id.* at Para 3.3(a).

Paragraph 3.2.3 prescribes that Foreign Venture Capital Investors ('FVCI')[48] are allowed to invest in VCF/AIF; however, if the domestic VCF/AIF is set up as a trust, then investment by a person resident outside India is subject to FIPB approval. It is notable that the same Paragraph goes on to state that if the domestic VCF/AIF is set up as a company, then investment by a person resident outside India is through the automatic route of the FDI scheme (subject to pricing guidelines, reporting requirements, mode of payment, minimum capitalization etc). These provisions clearly shows that there is an inherent bias against foreign investment in a trust set-up, vis-à-vis that in a company.

If the above is the law with respect to FDI in trusts, FIPB practice makes it amply clear that FDI in trusts is viewed through a prism of suspicion, and is consequently sought to be heavily regulated. For instance, in the 2009 FIPB Review,[49] it was observed that unlike a company, it was difficult to ascertain with whom the ownership and control of a trust lay.[50] It was further acknowledged that the application of DIPP Press Notes regarding downstream investment to trusts is difficult;[51] accordingly, the DIPP expressed concern that trust vehicles are largely unregulated.[52] It is no

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48 "Foreign Venture Capital Investor" is defined at Para 2.1.16 of the 2014 FDI Policy *as an investor incorporated and established outside India, which is registered under the Securities and Exchange Board of India (Foreign Venture Capital Investor) Regulations, 2000 and proposes to make investment in accordance with these Regulations.*

49 Foreign Investment Promotion Board, *Review 2009,* available at: < http://fipb.gov.in/Forms/FIPBREVIEW2009.pdf> (accessed 3rd April 2015).

50 *Id.* at Para 3.1.2 ("Ownership and Control of a Trust"), at pp. 27-28.

51 *Ibid.*

52 See, for instance, Moumita Bakshi Chatterjee, *FIPB Rejects Forum Synergies' Proposal,* THE HINDU BUSINESS LINE, available at: < http://www.thehindubusinessline.com/todays-paper/tp-corporate/fipb-rejects-forum-synergies-proposal/article1634842.ece?> (accessed 3rd April 2015).

surprise, then, that there have been news reports of proposals for FDI into trusts being rejected because the identity of the beneficiaries was unknown.

In the 2011-2013 FIPB Review,[53] the FIPB clarified that investments made *by* the VCF/AIF would be regarded as FDI and would have to conform to sectoral caps and conditions laid down in the FDI Policy. In the spirit of regulating the investors *into* the trust, the FIPB also seemed to suggest that a VCF/AIF could only raise funds from SEBI-registered FVCIs. Another condition imposed by the FIPB was that the investors must be resident in a country that is a member of the Financial Action Task Force and is a signatory to the International Organization of Securities Commissions' ['IOSCO'] Multilateral MoU.

Accordingly, it is clear that the foreign investment regime in respect of trusts is, at present, heavily regulated. The endeavour of the FDI Policy and the FIPB has been to regulate the *investors* into the trust, by requiring prior approval for all foreign investments,[54] and imposing certain other requirements in the larger interests of establishing safeguards against money laundering, terrorist financing and so on. It is submitted that such heavy regulation of the investment sphere with respect to trusts – with the regulator making it more and more arduous for investors to enter the Indian market – will ultimately have a detrimental effect on the real estate sector, which is riddled with heavy FEMA regulation as it is. Drawing upon this point, a

[53] Foreign Investment Promotion Board, *Review2011-2013,* available at: < http://www.fipb.gov.in/Forms/FIPBREVIEW2011-13.pdf> (accessed 2nd April 2015).

[54] Paragraph 3.2.3, 2015 FDI Policy.

commentator has formulated an attractive analogy to explain the present over-regulation of FDI by trusts, by referring to the *stage(s)* at which FDI Regulations would (and should) apply.[55] As per his analogy, investment in respect of a trust comprises of two "legs". The "first leg" is the issue of trust units to an investor, i.e. pooling or fund-raising. The "second leg" is the downstream investment *by the trust*. With regard to the latter, it is clear that it would be considered as direct FDI and would attract all pertinent restrictions under the FDI Policy, *viz.* sectoral caps, pricing and all other conditions. The problem arises in respect of the "first leg". Since the FDI Policy is silent on this point, it is unclear whether the initial investment (notwithstanding the requirement of FIPB approval) is also characterized as a direct FDI, and whether it must also comply with FDI rules such as pricing guidelines.

In the interests of promoting foreign investment, it is argued that the "first leg" should stand outside the FDI regime, since it is a *pooling of capital* and not a *deployment* of it. If the general purpose is to ensure a minimum amount of regulation, then the same has been met by the mandatory requirement of FIPB approval, and it is submitted that further regulation would merely make foreign investment into trusts more cumbersome and unattractive. The above suggestion, if adopted, would mean that foreign investment *into the trust* would be free from FDI conditions such as seeking approvals and pricing guidelines on purchase and sale/redemption of trust units. It would certainly be desirable if REIT investors were not subject to

55

pricing guidelines.

Therefore, it is clear that the law as it currently stands is marked by a cautious/suspicious approach to trusts as vehicles for FDI, and additionally, there is a discernible regulatory uncertainty with respect to the same. This uncertainty may have a detrimental effect on foreign investment in REITs. Should the channel of trusts as investment vehicles also be closed off to the real estate sector due to the over-enthusiasm of the regulator, it is difficult to fathom how the Indian real estate sector will attract investors and grow in the years to come. In this respect, the aforementioned commentator has suggested that it might be productive to begin from the ground up when laying down rules for investment into REITs and Infrastructure Investment Trusts, rather than trying to integrate these rules into the current FDI framework.[56] It is certainly hoped that the contentious issues highlighted above are addressed – and resolved – in the near future, in order to facilitate a successful introduction of REITs as a viable channel for investment into the Indian real estate sector by foreign and domestic investors alike.

X. CONCLUSION

As is clear from the above discussion, the two major changes that have occurred with respect to foreign investment in real estate have been *first,* the continued liberalization of the construction development sector, and *secondly,* the promulgation of the REIT Regulations. Despite the fact that foreign investment guidelines in respect of the latter are awaited, these

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56

developments have had a discernible impact on the real estate sector. For instance, several real estate companies – Indiabulls Real Estate, Godrej Properties and DLF, among others – made substantial gains on the stock markets after the PN12 changes were announced.[57] Further, it was recently reported that global sovereign funds are investing heavily in Indian real estate. GIC (Singapore) has reportedly entered into a joint venture with Delhi-based Vatika group to develop two housing projects in Gurgaon. Similarly, Abu Dhabi's ADIA has reportedly sought to invest $200 million in Indian real estate, in addition to its pre-existing stake in real estate/infrastructure companies such as Infrastructure Leasing & Financing Services and Red Fort Capital (a real estate private equity fund), while other funds such as Temasek (Singapore) and State General Reserve Fund (Oman) have also recently invested in the sector.[58]

With respect to the operationalization of REITs with foreign investment, it was recently reported that the Finance Ministry has floated a draft Cabinet Note for the enabling amendment of FEMA, which would permit foreign investment in REITs. On the strength of these reports, nine major realty stocks (such as DLF, Unitech, Godrej Properties, Parsvnath Developers etc.) made notable gains on the stock exchange. It is therefore clear that, in light of the recent developments, optimism in the real estate sector is high.[59]

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[57] See, *Real estate shares gain as government eases FDI norms,* BUSINESS STANDARD (11th November 2015), available at: < http://www.business-standard.com/article/markets/real-estate-shares-gain-as-government-eases-fdi-norms-115111100424_1.html> (accessed 26th January 2016).

[58] *Ibid.*

[59] See, *Realty Stocks gain on buzz govt to amend FEMA Act for foreign funds in REITs,* BUSINESS STANDARD (30th January 2015), available at: <http://www.business-standard.com/article/news-

The real estate sector in India has come a long way from the heavily regulated sector it once was. Construction development has not only opened up to foreign investment, but regulatory requirements have also been further eased to invite more foreign funding. Moreover, the introduction of REITs by SEBI is being seen by the industry as a bold and path-breaking move that could rejuvenate the sector by providing a much-needed infusion of capital. While detailed guidelines in this respect are awaited, it is hoped that the same address and resolve the stumbling blocks highlighted above. It is submitted that, the establishment of regulatory clarity coupled with a continuing effort to make the sector more investor-friendly will indeed revolutionize the Indian real estate sector, and take it from strength to strength.

cm/realty-stocks-gain-on-buzz-govt-to-amend-fema-act-for-foreign-funds-in-reits-115013001012_1.html> (accessed 2nd April 2015).