

M&A Hotline

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STREAMLINING ISSUANCE OF SUBORDINATE UNITS & ROLLING OUT UNIT BASED EMPLOYEE BENEFITS BY INVITS/REITS

Infrastructure Investment Trusts ('**InvITs**') and Real Estate Investment Trusts ('**REIT**') are investment pooling vehicles that invest in revenue generating infrastructure assets and real estate assets, respectively. The foundation for InvITs and REITs in India was laid down by Securities and Exchange Board of India ('**SEBI**') in 2014, by notifying the SEBI (Infrastructure Investment Trust) Regulations, 2014 ('**InvIT Regulations**') and SEBI (Real Estate Investment Trust) Regulations, 2014 ('**REIT Regulations**').

While the InvIT Regulations and REIT Regulations were enacted in 2014, the landscape surrounding InvITs and REITs are fairly in a nascent stage and hence, SEBI has time and again introduced various amendments/reports/consultation papers to bring about clarity to the InvIT Regulations and REIT Regulations. One of the guiding principles governing InvIT Regulations and REIT Regulations is that no unitholder of an InvIT or REIT, can enjoy any superior voting rights or any other rights over another unitholder^{1,2}. The only exception to the abovementioned principle is in relation to the issuance of subordinate units to the sponsors and its associates by the InvIT / REIT, where such subordinate units shall have inferior voting or any other inferior rights as compared to ordinary units.

While the InvIT Regulations and REIT Regulations allowed the issuance of subordinate units only to sponsors and its associates, the mechanism and the terms and conditions applicable to such subordinate units was unspecified as the InvIT Regulations and REIT Regulations did not legislate on the abovementioned issue. In order to provide color on the same, the SEBI vide consultation papers dated December 09, 2023 ("**First Consultation Paper**") and January 10, 2023 ("**Second Consultation Paper**"). The First Consultation Paper and Second Consultation Paper are collectively referred to as '**Consultation Papers**') sought comments from the stakeholders on the proposed framework for issuance of subordinate units by InvITs / REITs to the sponsors and its associates. Secondly, akin to the concept of companies devising employee stock options to align the interests of the company with the interests of the employees, the First Consultation Paper sought comments from the stakeholders on the proposed framework for unit based benefits for the employees of the investment manager of the InvIT / manager of the REIT. In this article, we have analyzed the framework proposed by SEBI pursuant to the Consultation Papers.

1. WHAT ARE SUBORDINATE UNITS?

Subordinate units are issued by the InvIT or REIT to only the sponsor and its associates typically in scenarios where there is a gap in the valuation of an infrastructure asset / real estate asset as perceived between the sponsor (the transferor) and the InvIT/REIT (transferee), respectively (such difference being referred to as '**Bridge Valuation**'). In order to address the Bridge Valuation, typically, InvITs or REITs issue subordinate units equivalent to the Bridge Valuation, to the sponsors and their associates. The aforementioned subordinate units are inferior to ordinary units in terms of voting or other associated rights. Within a specified period of time or upon the satisfaction of certain specified events, in circumstances where the InvIT/REIT is in agreement with the valuation perceived by the sponsor of the infrastructure asset / real estate asset, the subordinate units issued by such InvIT / REIT to the sponsor, are converted into ordinary units of such InvIT / REIT

Illustration

ABC InvIT ("**Purchaser**") is proposing to acquire a road asset from its Sponsor ("**Seller**"). The Purchaser values the road asset at INR 10,000 crore and the Seller values the road asset at INR 12,000 crore. In order to bridge the difference in the valuation perceived by the Purchaser and the Seller (i.e.- the Bridge Valuation), the Seller may subscribe to ordinary units of the Purchaser equivalent to INR 10,000 crore and subordinate units of the Purchaser equivalent to INR 2,000 crore. The terms and conditions for issuance of such subordinate units may provide for the conversion of the subordinate units to ordinary units upon fulfillment of certain specified events (typically relating to the performance of the transferred road asset, such as the volume of traffic) within a period of 5 years from the date of issuance of the subordinate units. Upon consummation of such specified events, the subordinate units shall convert into ordinary units of the Purchaser.

2. PROPOSED FRAMEWORK FOR ISSUANCE OF SUBORDINATE UNITS BY INVITS / REITS

On July 19, 2022, SEBI's Hybrid Securities Advisory Committee laid the foundation stone by providing a framework for the issuance of subordinate units by InvITs / REITs. On the basis of the abovementioned framework, SEBI vide the First Consultation Paper invited the stakeholders to provide their comments on the below mentioned proposed framework for issuance of subordinate units by InvITs / REITs to the sponsors, its associates and sponsor group:

1. Subordinate units can be issued in the initial offer or in any offering subsequent to the initial offer, subject, to the

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- approval of 75% of the unitholders by value (excluding the sponsors, sponsor group, associates of sponsors and other related parties to the transaction);
2. Subordinate units shall be (a) unlisted, (b) issued in the dematerialized mode and (c) bear a separate ISIN;
 3. For the purpose of calculating the mandatory minimum unitholding of sponsor and sponsor group, subordinate units shall not be taken into consideration;
 4. The terms and conditions governing the subordinate units, including but not limited to the entitlement date / event and the performance benchmark for conversion of subordinate units to ordinary units, shall be included in the trust deed and disclosed in the offer document / placement memorandum. The performance benchmark mentioned in the aforementioned documents should be quantifiable and based on the audited financials;
 5. Lock-in period of 1 year shall be applicable on the subordinate units, provided, such lock-in shall not be applicable to inter-se transfer of subordinate units amongst the sponsors, their associates and sponsor group;
 6. Time gap of atleast 1 year should apply between the date of issuance of subordinate units and the entitlement date / event for conversion of subordinate units into ordinary units;
 7. One-time extension in the entitlement date (as specified in the offer documents / placement memorandum / placement document) may be permitted for a maximum period of 1 year subject to (a) receiving the approval of 75% of the unitholders by value (excluding the sponsors, their associates, sponsor groups and related parties to the transaction), (b) such extension being duly contemplated and approved prior to the issuance of subordinate units and (iii) adequate disclosures relating to such extension being specified in the offer document / trust deed / placement document / placement memorandum;
 8. Extinguishment of the subordinate units without any payment to its holders in circumstances where the performance criteria is not met at the end of the entitlement date (as certified by the statutory auditors);
 9. Till the time the subordinate units are outstanding, the investment manager / manager of the InvIT / REIT, respectively shall disclose the net asset value and the distribution per units (including and excluding the subordinate units); and
 10. Upon issuance of the subordinate units, the terms and conditions of such issued subordinate units can be changed only in circumstances where the approval of (i) 75% of the unitholders by value (excluding the sponsors, their associates, sponsor groups and related parties to the transaction); and (ii) 100% of the unitholders of subordinate units; is received.

Subsequent to receiving certain feedback from the stakeholders, SEBI vide the Second Consultation Paper proposed the following additional framework:

1. **Inferior voting / distribution rights.** Subordinate units shall only carry inferior voting rights or inferior distribution rights or both, provided, such inferior rights on all subordinate units shall be similar. Hence, there shall be no multiple classes of subordinate units.
2. **Uniformity of rights on subordinate units.** In order to bring about uniformity across the industry with regard to the extent of inferior rights offered on the subordinate units, the following framework was proposed by SEBI:
 1. Subordinate units carrying no distribution and no voting rights; or
 2. Subordinate units carrying inferior distribution rights and inferior voting rights to the extent of 10% of the corresponding rights conferred on ordinary units; or
 3. Combination of floor and cap (i.e.- a range) as to the extent of inferior distribution rights and inferior voting rights which can be offered on subordinate units vis-a-vis ordinary units.
 4. **Ceiling on the issuance of subordinate units.** In circumstances where the subordinate units are converted to ordinary units, the ordinary unitholders' existing ordinary unitholding would be diluted. In order to prescribe a ceiling with respect to the extent of the abovementioned dilution, SEBI aimed at capping the issuance of subordinate units to a number not exceeding 10% of the (i) acquisition price of the asset and (ii) total number of outstanding ordinary units.
 5. **Removal of changes to terms and conditions of subordinate units.** Considering the fact that the terms and conditions of the subordinate units are mutually agreed between the InvIT/REIT and the sponsor, it would not be conducive to allow changes in the terms and conditions of such subordinate units subsequent to its issuance by the InvIT / REIT to the sponsor. In light of this, SEBI proposed to remove the framework allowing the alteration of the terms and conditions of subordinate units (i.e.- removal of point numbers (vii) and (x) above).

3. PROPOSED FRAMEWORK FOR UNIT BASED EMPLOYEE BENEFITS FOR INVITS / REITS

In order to align the interests of the InvIT / REIT with the interests of the employees of the investment manager / manager of the InvIT / REIT, respectively, SEBI vide the First Consultation Paper prescribed the proposed framework for implementation of the Unit Based Employee Benefit Scheme ('UBEB Scheme'). The UBEB Scheme is proposed to be implemented in the following manner:

1. Establishment of a separate Employee Benefit Trust ('EB Trust') by the investment manager / manager of the InvIT / REIT, respectively;
2. Investment manager of the InvIT / manager of the REIT shall offer its existing units to the EB Trust or the investment manager of the InvIT / manager of the REIT may subscribe to the units of the InvIT / REIT, in lieu of management fees, subject to such issuance of units being (a) approved by 75% of the unitholders by value (excluding the sponsors, their associates, sponsor groups and related parties to the transaction) and (b) undertaken once in an year, within 60 days from the date of completion of the annual valuation exercise;

3. The issue price in relation to issue of units to the EB Trust in lieu of management fees shall be determined basis the higher of the following;

1. Net asset value of the units as per the latest available valuation report (not older than 60 days);
2. Market price of the units which shall be determined in the same manner as mentioned in the guidelines for preferential issue of units;
3. The issue price of any issuance of units made by the REIT/InvIT within the preceding 6 months from the date of issuance of units in lieu of management fee.
4. Trustee of the EB Trust shall not be entitled to vote and the unitholding of the EB Trust shall be shown as "non-sponsor and non-public" unitholding for the purposes of disclosures to recognized stock exchanges; and
5. Any distributions received on the units held by the EB Trust shall be utilized by the EB Trust to acquire further units of the InvIT / REIT solely for the purpose of implementing the UBEB Scheme.

4. CONCLUSION

While the Consultation Papers provide the much needed clarity on the framework for issuance of subordinate units by InvITs / REITs to sponsors, sponsor group and its associates, it does not address the issues surrounding the legality of the existing subordinate units issued by the InvITs / REITs. In circumstances where the proposals specified in the Consultation Papers sees the light through amendments to the InvIT Regulations and REIT Regulations, it will be interesting to see if SEBI allows the grandfathering of the subordinate units issued previously by the InvITs and REITs.

Additionally, the proposed framework relating to the implementation of UBEB Scheme acts as a catalyst for aligning the interests of the InvIT / REIT with the interests of the employees of the investment manager / manager of the InvIT / REIT, respectively.

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You can direct your queries or comments to the authors.

¹Regulation 4(2)(h), SEBI (Infrastructure Investment Trusts) Regulations, 2014

²Regulation 4(2)(g), SEBI (Real Estate Investment Trusts) Regulations, 2014

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