

## Challenges and Opportunities for Public Infrastructure REITs in China

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### ABSTRACT

With the enactment of the “Notice on Promoting the Pilot Work Related to Real Estate Investment Trusts (REITs) in the Infrastructure Sector” in 2020, China has opened a new era of public infrastructure REITs on the mainland jurisdiction. Based on this background, this paper summarizes the complex operational structure of public infrastructure C-REIT, analyzes the potential legal risks of the structure accordingly, and proposes corresponding suggestions for improving the investor protection mechanism of public infrastructure C-REIT.

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### Introduction

Since 2005, when China issued its first REITs abroad [1]. The Chinese government and scholars have never stopped exploring REITs. In order to promote a whole new development pattern of the country, China has proposed a series of policies to deepen the reform of national financial system and enhance the ability of financial services to the substantial economy [2]. Under this context, the Chinese REITs (C-REIT) are introduced in the infrastructure field, which function as a significant instrument to revitalize the stock assets, broaden the investment channels of social capital and strengthen the quality and efficiency of serving the real economy, which is regarded as a milestone of financial innovation in China [3].

However, the global economic development and financial markets have taken a huge hit since 2020 due to the epidemic [4]. Furthermore, the spread of the Omicron virus will continue to pose a tremendous risk to the inclusive and sustainable recovery of the world economy. The Global Economic Prospects released by the World Bank likewise projects a significant slowdown in global economic growth, which it forecasts the growth of 4.1 percent in 2022 and 3.2 percent in 2023 [5]. In the globalization context, China can barely stay away from it. The World Economic Situation and Prospects for 2022, published by the United Nations, indicates that China’s annual economic growth will slow to 5.2% in 2022 and is forecast to be around 5.5% in 2023, based on the national economic performance; and, China’s export and investment drivers are declining, and the epidemic prevention and control measures are having a significant impact on both services and consumption [6]. China’s capital market is no exception. In the Asset Securitization Development Report 2020, the researchers said that although the overall growth trend of the stock size at the end of the year continued, exceeding 5 trillion yuan, the issuance

of the Chinese asset securitization market still received fluctuations due to the impact of the epidemic, and still showed a certain downward trend in the early days of the epidemic [7].

In this context, in April 2020, the China Securities Regulatory Commission (CSRC) and the National Development and Reform Commission (NDRC) jointly issued the Notice on Promoting the Pilot Work Related to Real Estate Investment Trusts (REITs) in the Infrastructure Sector, which initiated the pilot project of China mainland infrastructure REITs [8]. Subsequently, in August, the CSRC issued the relevant “Guidelines for Publicly Offered Infrastructure Securities Investment Funds (for Trial Implementation)” (hereinafter referred to as “Guidelines”), which clarified the product definition, operation model, fund share offering method and other specific implementation rules for publicly offered infrastructure REITs to guide the implementation of the pilot project [9]. This means that China will no longer issue REITs only in the private sector, but will open a new era of public REITs by learning from the advanced experience of the United States, Japan and other countries [10]. Eventually, in June 2021, the first nine domestic public infrastructure REITs were listed on the Shanghai and Shenzhen Stock Exchanges; by the end of 2021, a total of 11 infrastructure REITs were listed, including property rights REITs such as logistics and warehousing and industrial parks, and concession REITs such as highways, water treatment and waste-to-energy generation [11].

Since then, based on public policy considerations and the success of the pilot, in July 2021, the National Development and Reform Commission issued “No. 985” to further expand the scope of underlying assets for public REITs based on the Guidelines, including areas such as guaranteed rental housing, new infrastructure, clean energy and tourism infrastructure, etc [12]. However, due to the complexity of the structure of C-REIT, the diversity of participating parties and underlying asset classes, and its transition from the private to the public sector, it will

have to face the challenges of inadequate regulatory and investor protection mechanisms, as well as the lack of a corresponding tax system.

### Operational Structure of Public Infrastructure C-REIT

According to the Guidelines issued by the CSRC, the infrastructure REITs have a number of major participants, including: originator, investor, fund manager and custodian, ABS manager and custodian, intermediary agencies providing professional services, operation management agencies, etc. Besides, Article 2 of the Guidelines lists four typical features of China’s infrastructure REITs: “(1) More than 80% of the assets of the fund are invested in infrastructure asset-backed securities [13], to hold all of their shares; and the fund holds all the equity of infrastructure project companies through the infrastructure asset-backed securities; (2) The fund acquires full ownership or right of operation of an infrastructure project through asset-backed securities, a project company, or any other vehicle (hereinafter collectively referred to as the “special purpose vehicle”); (3) A fund manager voluntarily operates and manages an infrastructure project with the main purpose of obtaining stable cash flow such as rent and fees for the infrastructure project; (4) Closed-end operation shall be adopted, and the income distribution ratio shall not be lower than 90% of the fund’s consolidated annual funds available for distribution [14].

Based on the provisions of the Guidelines, combining with the report of Shanghai Stock Exchange on the introduction of infrastructure public offering REITs, this paper sorted out the complex operation process of REITs (as figure 1 show) [15]. China is currently promoting infrastructure REITs to take one special structure regulated by the CSRC, where the ‘Public Fund & ABS (Asset-Backed Security)’ are the core of double ‘special

purpose vehicle(SPV)’; the ‘Public Fund’ will raise money from public investors and take securities as the investment objects; and the ‘ABS’ is one special purpose vehicle established by the fund management or securities company for operating the asset securitization business [16].

Specifically, as figure 1 illustrates, the managers and custodians play an important role in the fund management. Considering their professional skills and experiences, investors will have confidence and trust on them, and transfer their money to the fund, which must be separated from the property of managers and custodians. During the management and operation of fund, the fund managers or fund custodians “shall be dutiful, perform its obligations of good faith, prudence, and diligence, abide by the basic principle of giving priority to the interests of holders, effectively prevent conflicts of interest, and achieve professional management and custody” [17]. Furthermore, the originator is also required to hold a certain amount of shares in the fund for a certain period of time, in order to hedge the potential moral hazard of the infrastructure owner [18, 19]. Besides, in order to reduce management risks and costs, the Guidelines stipulate further requirements on the relationships between the manager and custodian of ABS and fund. For example, Article 6 of Guidelines demands that the custodian of public infrastructure fund shall be the custodian of ABS; Article 25 requires that fund manager must have an actual control relationship with ABS’s manager, or they are all controlled by the same controller. It can be seen that the product structure of public infrastructure REITs in China is very complex, involving multiple types of market participants and multilevel agent relationships.

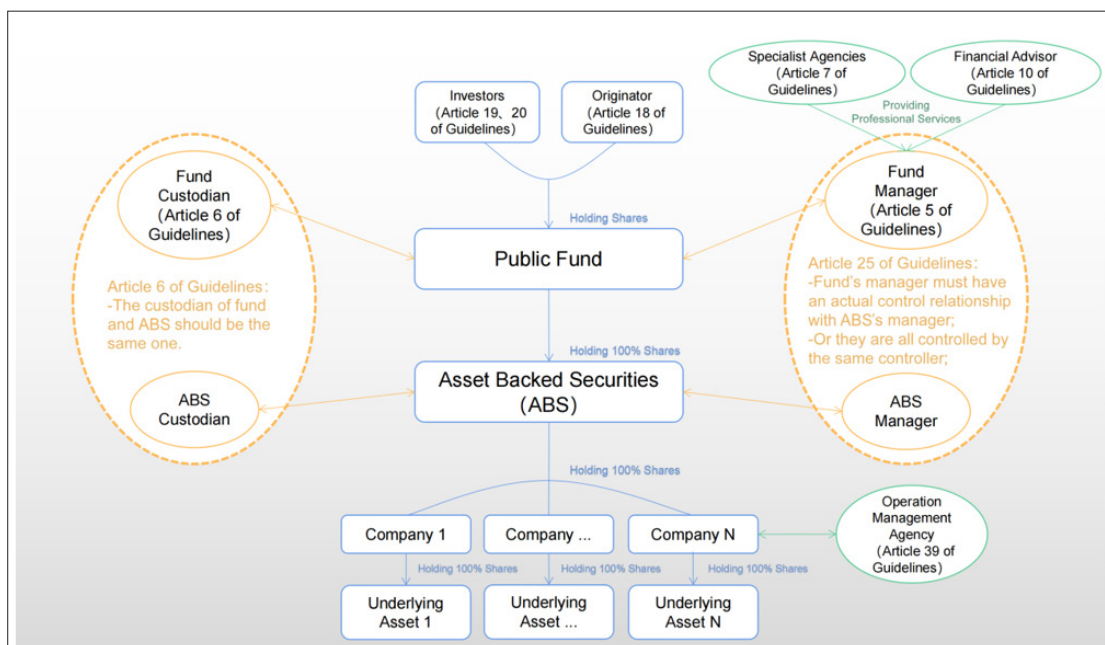


Figure 1: The Structure of China’s Infrastructure REITs

In China, public infrastructure REITs, i.e., securities investment funds, as a financial product alongside stocks and bonds, its establishment, operation and other related activities are mainly governed by the Securities Law of the People’s Republic of China (hereinafter referred to as “China’s Securities Law”) and the Law of the People’s Republic of China on Securities Investment Fund (hereinafter referred to as “China’s Securities Investment Fund Law”) and other relevant laws and regulations [20]. However, the Article 2 of China’s Securities Investment Fund Law stipulates that “the present Law shall apply to the securities investment activities conducted through the method of portfolio and through public offering of fund shares to raise securities investment fund (hereinafter referred to as fund), which is managed by fund managers and entrusted to fund custodians for the benefits of the fund shareholders; the matters

not covered by the present Law shall be governed by the Trust Law of the People's Republic of China, the Securities Law of the People's Republic of China..."[21]. Therefore, when it comes to the regulation of contractual funds, like public infrastructure REITs, in mainland China jurisdiction, China's Securities Investment Fund Law is actually the special law to China's Trust Law and Company Law [22, 23].

Besides, it is worth noting that in China, considering specific historical and social factors, the trust relationship adopted by Chinese Trust Law is a tripartite contractual arrangement model, [24]. Which is completely different from the "trust structure" in countries with a long history of trust law, such as the United Kingdom [25]. Therefore, although Chinese public infrastructure REITs are argued by many Chinese scholars to have certain "trust features", they are "contractual relationship" in nature, as the trust itself in mainland China is a multi-party contractual arrangement [26]. In addition, in order to further improve the regulatory system for public infrastructure REITs, the CSRC has issued a series of circulars and guidance for the funds, and the Shanghai and Shenzhen Stock Exchanges have provided corresponding management rules for them [27, 28]. As can be seen, in mainland China, with the categorization of the regulation of financial products under the higher law, there may be much complexity in the application of the law, and in practice we may need to rely more on the Guidelines and the specific terms of the fund contract achieved by the parties to deal with the series of issues of public infrastructure REITs [29].

#### **Agency Risks of Public Infrastructure C-REIT Conflicts between Trustees and Investors**

According to the summary of the operation mode of REITs above, it can be concluded that REITs are mainly composed of three layers: public funds, ABS and the invested company (or Project Company). However, since the Guidelines do not prohibit ABS from indirectly owning rights to project companies and infrastructure through SPV, infrastructure REITs could theoretically add SPV to this three-tier structure to form a four-tier or even five-tier investment structure [30]. In addition, due to the imperfect regulatory system for infrastructure REITs, this multi-tier architecture will pose a series of problems during the future operation and management of REITs.

In a public infrastructure C-REIT structure, investors in a public fund delegate the management and investment rights of the fund to the fund manager, which creates agency risk between the fund managers (trustees) and the fund shareholders (principals)? First of all, the value of REITs mainly depends on the professional management and reasonable investment decisions of the fund and underlying assets by the manager, but traditional public fund managers in China lack sufficient practical experience in the operation and management of such "non-standard large-scale assets" as infrastructure [31]. For a long time, they have mainly invested in standardized securities in the secondary market, however, there is no such open competitive market for renting and trading real estate. Therefore, in an environment where there is a lack of open market competition without public market prices for reference, entrusting assets to the fund manager may cause higher moral hazard [32].

Second, the fund manager's source of profit is mainly the management fee during the operation of the REITs, but the fee is mainly calculated based on the size of the fund and is paid by the fund property, so the manager will naturally have a pursuit of "fund size expansion and dividend yield" [33, 34]. Therefore,

in the absence of supervision, they may blindly expand the size of the fund and may even make investment decisions that are contrary to the interests of the fund owners, failing to fulfill their obligations of "honesty, integrity, prudence and diligence" [35].

In addition, the Guidelines also provide that "the fund manager may establish a special subsidiary to undertake the operation and management of the infrastructure project" [36]. While this provision is intended to avoid conflicts of interest within the managers to facilitate effective management of the underlying assets, it also provides an avenue for the managers to transfer benefits, especially in the context of the current immature regulatory regime for C-REITs. For example, fund managers may sell assets not eligible or businesses operated by themselves to the portfolio companies at a high price, or hire professional services not qualified, or other investment decisions and transactions detrimental to investors.

Moreover, the multi-layer structure of REITs may result in the co-existence of multiple managers [37]. Although the Guidelines require that the fund manager and the ABS manager should have an actual control relationship or share the same controller in order to minimize intra-manager conflicts [38]. However, this does not get to the root of the problem. If the division of responsibilities between different asset managers is unclear, then conflicts of interest within the managers will not be resolved, which will undoubtedly further raise the cost of management and agency. Meanwhile, as a public financial product, its complex operating structure makes it difficult for ordinary investors to sort out the legal relationships and clearly recognize the potential legal risks of each layer of the structure; combined with the large information and experience gaps between investors and managers, such information asymmetry can also further increase agency costs [39].

#### **Conflicts between Originator and Investors**

Furthermore, during the operation of public infrastructure C-REITs, the conflict of interest between originator and investors may also lead to the problem of agency risk. When establishing REITs, the Originator, as the original owner of the infrastructure project, is generally the party that is most familiar with the characteristics of the underlying assets. In a profit-oriented economic market, they may be reluctant to completely transfer the management rights of some "high-quality assets" to the manager, which may lead to a kind of "Adverse Selection" problem [40]. In this case, originator may prefer to transfer infrastructure projects that are less valuable to them, have less potential for development or have lower quality assets in an attempt to "cash out" [41]. Alternatively, they may become the "controller" of the fund by retaining a majority of the fund's shares, and participate in the management of the underlying assets to engage in abusive control behaviors such as affiliate transactions or transfer of benefits [42]. Because many non-standard assets, such as logistics warehouses, power generation facilities, sewage treatment and other infrastructure, are either fixed assets necessary for the operation of the originators or can only be operated and managed by the originators. In this scenario, although the fund management company is entrusted the role of "fiduciary" for asset management by the Guidelines, it can only delegate the management of assets to the originators or jointly with them [43].

In addition, considering the high supervision cost, there may be some "free rider" phenomena, i.e., those small and medium-sized fund investors may rely excessively on the originator who owns a high proportion of fund shares. However, these originators, as subjects of information superiority, will most probably ignore



the interests of minorities or even make decisions against the interests of them.

### **Inadequacy of Information Disclosure System**

In the Guidelines issued by the CSRC, the primary disclosure obligation is the “fund manager”, which undertakes heavy disclosure responsibilities throughout almost all processes of public infrastructure C-REIT [44]. Considering the extremely complex operational structure of public infrastructure C-REIT, it would be difficult to guarantee the adequacy and reliability of the information available to investors if the major information disclosure duties are assigned to only a single entity. Although the Guidelines stipulate the disclosure obligations of the originators, it only requires that they shall comply with the disclosure obligations in accordance with “the relevant provisions”, but do not specify which regulations and how to fulfill the duty of disclosure [45]. Furthermore, the Guidelines also provide for the disclosure duty of matters related to the convening of fund shareholder meetings, but do not specify who should burden the disclosure obligations, and only require the “relevant parties” to comply with the disclosure requirements under the law [46]. Therefore, the vagueness and uncertainty of the subject and the content of disclosure obligations in the Guidelines may also cause a major hindrance to the effective implementation of information disclosure obligations.

Besides, the Guidelines also require the “operation management agency”, delegated by the fund manager to manage the portfolio companies, [47]. Shall “cooperate with” the “fund manager and other parties” to fulfill the latter’s information disclosure obligations and ensure the truthfulness, accuracy and completeness of information [48]. However, in the structure of multiple obligators, merely demanding that one “shall cooperate” with another to fulfill its disclosure obligations without the specific contents and methods of duties may, in practice, lead to unclear division and mutual shirking of responsibilities.

Moreover, although the Guidelines stipulate that the fund custodian can supervise and review the fund manager’s “information disclosure behaviors” this “supervisory power” lacks a certain degree of compulsion or enforceability [49]. Because the custodian is still under the oversight of the fund manager [50]. As a regulated person with relatively few rights, it is difficult for a custodian to have sufficient authority to oversee a more empowered party, the fund manager.

Furthermore, the Guidelines do not explicitly state the liability for the breach of information disclosure obligations, and the China’s Securities Investment Fund Law does not adopt “the presumption of fault” for damages caused by a breach of information disclosure obligations as the Securities Law does [51]. Therefore, under the China’s Securities Investment Fund Law, when the interests of investors in REITs are harmed, they need to prove the fund manager has acted “at fault”, which is very challenging for medium-sized investors who are in a disadvantaged position, and will impose them an excessive burden of proof and raise the defense cost [52].

The Guidelines provide that “the right to make specific disclosure rules” is assigned to the “stock exchange” but it does not seem to have accomplished its intended purpose [53]. For example, the Shanghai Stock Exchange has issued corresponding “Business Guidance” to further clarify two types of information disclosure subjects: the first is “the subject of information disclosure obligation of public fund and ABS”; the second is “the subject of information disclosure obligations in the acquisition of public

funds and the activities causing changes in fund share interests” [54]. However, the Business Guidance just imposes less stringent “self-regulation” on these obligated entities, and the exchange states that they are not responsible for the “truthfulness, certainty and completeness” of the content of ongoing disclosures during the operation of the fund [55, 56].

### **Inadequacy of Tax System**

At present, China has not yet introduced corresponding laws and regulations for the taxation of public infrastructure C-REIT. Under China’s current tax regime, public infrastructure C-REIT involves a number of tax matters in its establishment, operation and exit stages. In the set-up segment, different taxes will be levied depending on different transaction patterns [57]. If the REITs are established by “transfer of equity”, they may be subject to stamp tax; If a “asset transfer” method is used, both deed tax and stamp tax may be imposed. In the operation of REITs, a series of taxes may be involved due to the holding and management of the underlying assets, such as VAT, stamp duty, property tax, land use tax and corporate income tax, etc. Finally, when REITs complete their contractual terms and need to exit the market, they are subject to a complex set of taxes when transactions such as asset or equity transfers occur [58].

In addition, due to the lack of specific tax policies, under China’s complex tax system, the cost of operation of REITs might be higher. For example, even though REITs do not materially transfer real estate in the financing process, they are subject to high taxes under the terms of transferring real estate, resulting in higher costs of divestiture, which is not conducive to revitalizing the social stock of assets. For example, even REITs do not materially transfer real estate in the financing process; they are still subject to high taxes in practice, which means they still need to pay the tax just like they had transferred real estate, even if they don’t. Obviously, this will result in higher costs of divestiture, which is not conducive to the revitalization of social stock [59]. Moreover, due to the complexity of China’s current taxation system for underlying assets and commercial transactions, investors in the public infrastructure C-REIT will be subject to unavoidable economic double taxation, which will significantly constrain the development of public infrastructure REITs in China [60].

### **Suggestions: How to Improve Investor Protection System Clarifying the Information Disclosure Obligations of Different Participants**

Therefore, in order to mitigate such agency risks and promote the investor protection regime, we need to take certain measures to further improve the regulatory system supporting public infrastructure C-REIT. First, it is the improvement of the information disclosure system of REITs to guarantee the timeliness and effectiveness of investors’ access to the relative information, and establish a systematic information disclosure system with diversified parties and multi-layered structure. The content of disclosure obligations can be formulated more specifically for different participants within structure of C-REIT, avoiding assigning most of the onerous disclosure obligations to the fund manager [61]. Thus, when drafting the fund contract, it is essential to avoid ambiguity and uncertainty in the contractual provisions regarding the contents and subjects of information disclosure obligations, to avoid the phenomenon of mutual shifting of responsibilities.

### **Emphasizing the Responsibilities of “Fiduciaries”**

Secondly, based on China’s special historical tradition, the fiduciary duty is not a long-established doctrine in the Chinese

legal system. China has no clear definition of the fiduciary duty owed by the trustee to the beneficiaries, especially in the business trust [62]. In addition, as noted above, within mainland China, commercial trusts are generally based on a trust contract, “a kind of multi-party contractual arrangement” that differs significantly from traditional international trust structure. Therefore, it may be a good opportunity to make suggestions for the reform of China’s business law. Through publishing statutory laws, judicial interpretations or guiding cases, or formulating relevant industry rules to specify and reinforce the responsibilities of trustees, such as those fund managers, and to draw definite boundaries for the fiduciary duties, so as to promote the attention of regulators and industry associations in this area. On the foundation of China’s local conditions, we can learn from overseas advanced theories and experiences, such as the Trustees Act 1967 of Singapore and the Trustee Act 2000 of the United Kingdom, to further refine and clarify the content of “fiduciary duty” through separate legislation, solving the problem of ambiguous internal responsibilities of trustees and unclear allocation, and further improving the investor protection system of REITs [63- 65].

### **Emphasizing the Functions of Industry Associations**

Furthermore, the supervisory and coordinating functions of trade associations in practice deserve to be emphasized to facilitate the construction of positive industrial interaction rules and regulatory environment. In the Guidelines, the self-regulatory rules and supplementary supervisory role of industry associations have also received some attention, but the content of the provisions is rather vague, and more detailed specifications need to be further developed to guide the cooperation between industry associations and REITs’ participants [66]. Many industry associations, such as Securities Association of China (SAC) and Asset Management Association of China (AMAC), are an integral member of external oversight due to their specific roles and functions, which allow them to access timely data and empirical information on the operation of local fund programs. For example, the U.S. Nareit is an official international trade association with very high information transparency [67]. We can learn from its advanced technology and experience, and then create an auxiliary platform for information and data disclosure within the REITs territory, which could cooperate with various financial intermediaries and regulators to form a diversified regulatory mechanism. In addition, this regulatory digital technology can promptly identify the loopholes in the market that need to be filled and the mistakes that need to be avoided, and cooperate with government regulators to summarize the successful practical experience in the market and provide the industry with a more complete template or model for guiding fund contracts, reducing the cost of commercial transactions and improving the operational efficiency of REITs at the same time [68].

### **Bridging the Gaps in the Tax System**

Compared with many countries with sophisticated REITs markets, China’s tax system still has a lot of deficiencies to make up in the field of REITs. It is necessary to refer to the advanced taxation system overseas and introduce it into China’s local taxation system in order to promote the operational efficiency of REITs and reduce the heavy taxation of investors. For instance, since the creation of REITs in 1960, the U.S. government has detailed the tax elements of REITs in its “Internal Revenue Code of 1986” and has been issuing new tax policies to encourage investors to participate in real estate gains [69]. As was the case in the Tax Cuts and Jobs Act of 2017, REITs investors continues to receive more tax benefits with each new draft of the tax code [70]. REITs, like many corporations, distribute income to investors in the form of

dividends. However, through reform of the tax system, income from REITs is no longer taxed at the corporate level in the United States. This means that the investors of the fund in the United States could avoid the horrendous “economic double taxation”, i.e., being taxed on both the corporate and personal income, and thus they are taxed only once [71]. This is one of the main factors why a number of investors place a premium on REITs over many other dividend-paying corporations. Additionally, when Japan introduced REITs in its jurisdiction, the Japanese government designed the corresponding product structure and tax elements at the same time, and provided a series of tax incentives to alleviate the pressure of double taxation. For instance, under the Special Taxation Measures Law, the Japanese REIT will be allowed to deduct distributed dividends from its taxable income if certain requirements are met [72]. It is because of these policies that the Japanese REITs market has grown to become one of the largest in the world.

### **Conclusion**

Through the research and analysis, this paper finds that: Currently, China’s public infrastructure REITs adopt a complex double SPV structure, i.e. “Public Fund & ABS”, which consists of various participants and multiple investment structures, increasing the difficulties and problems of management and supervision.

Firstly, this multi-level investment structure can lead to different kinds of agency risks. In addition to agency risk in traditional corporate governance, in closed public infrastructure REITs, due to the lack of an open bidding market, trustees may engage in investment practices that are contrary to the interests of investors, raising a series of moral hazard issues. In addition, the fund managers in mainland China may lead to problems detrimental to the development of public infrastructure C-REIT in practice, such as inefficient investment and management, due to the lack of experience in long-term management of non-standard assets. Considering the management fee payment mechanism of public infrastructure C-REIT, those fiduciaries, like the fund and ABS managers might be driven by profit to blindly expand the scale of fund to capture more remuneration, breaching the duties of good faith, care and diligence. Furthermore, due to the special structure of China’s public infrastructure REITs, there are potential problems with the co-existence of multiple layers of managers, resulting in unclear division of responsibilities. And, with this complex structure, it is difficulty to avoid the potential transfer of benefits between the manager and its affiliates, such as those operation management agencies delegated or the ABS managers controlled by the public fund manager. Moreover, there is a serious information asymmetry problem between the investors and originator, who is the original owner of underlying infrastructural assets, which may lead to many agency issues between them, such as the adverse selection problem of the originator.

Furthermore, based on the analysis of the specific provisions of the Guidelines issued by the CSRC, this paper finds that there are serious deficiencies in the current disclosure system for public infrastructure C-REIT. According to the Guidelines, the primary subject burdening information disclosure obligation is the public fund manager. However, considering the complicated structure of public C-REIT, the challenge of allocating onerous disclosure obligation on a single participant is actually bigger. In addition, although the Guidelines stipulate other subjects of information disclosure obligations such as custodians and external management agencies, the contents of the responsibilities are very ambiguous. In addition, some articles indeed rule specific information disclosure duties, but lack clarity as to who will assume the obligation.



Moreover, since the regulations of Guidelines do not specify rules on the burden of proof in litigation and the contents of liability for damages caused by violation of information disclosure duties, this will significantly escalate the cost for investors to defend their rights in judicial proceedings.

Therefore, based on studies of countries with mature REITs market and regulatory experience, such as the United States and Japan, this paper proposes a series of recommendations on investor protection in the final section, including the suggestions on improving the tax system, refining the information disclosure regime, emphasizing legislation on the fiduciary duty and promoting the supplementary regulation by industry associations, in the hope of facilitating the further development of China's public infrastructure REITs.

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