client alert

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ahead of the curve

Corporate Governance Frameworks for InvITs and REITs notified

The Securities and Exchange Board of India ("**SEBI**") amended the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**Listing Regulations**"), on January 17, 2023, to clarify that the provisions therein will not apply to infrastructure investment trusts ("**InvITs**") and real estate investment trusts ("**REITs**", and together with InvITs, "**Business Trusts**"). It further mentioned that Business Trusts would be required to comply with specific governance norms provided under the regulations governing them, viz. the Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014 ("**InvIT Regulations**"), and the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014 ("**REIT Regulations**").

Following this, on February 14, 2023, the SEBI has notified the Securities and Exchange Board of India (Infrastructure Investment Trusts) (Amendment) Regulations, 2023, and the Securities and Exchange Board of India (Real Estate Investment Trusts) (Amendment) Regulations, 2023 (together, the "**Amendments**"), to prescribe specific governance norms that will be applicable to Business Trusts, going forward.

The key highlights of the Amendments are as follows:

A. Changes applicable with effect from the date of notification of the Amendments

1. Strengthening the Audit Framework

a. Term of Auditors

Whilst the REIT and InvIT Regulations included detailed provisions on appointment and role of auditors, the Amendments have provided clarity on the term of office and conditions for re-appointment of auditors, consistent with the requirements applicable for listcos.

Pursuant to the Amendments, Business Trusts shall be required to appoint an individual or a firm as the statutory auditor for a term of five years (i.e. from the date of conclusion of the annual meeting in which the auditor has been appointed till the date of conclusion of the sixth annual meeting of Unitholders). Given that the first auditors are appointed by the investment manager, prior to listing of the Business Trust, it is pertinent to note that the term of appointment of the Business Trust's first auditor, shall be counted from the date of conclusion of the first annual meeting of Unitholders held post listing.

Further, it has been clarified that Business Trusts shall not be permitted to appoint (i) an individual as an auditor for more than one term of five years; and (ii) an audit firm as the auditor for more than two consecutive terms of five years. In line with the conditions applicable to listcos, (i) an individual who has completed the initial five year term shall be ineligible for re-appointment as the auditor of the same Business Trust unless a cool-off period of five years has elapsed from the date of completion of the term; and (ii) an audit firm that has completed two consecutive terms of five years shall be ineligible for re-appointment as the auditor of the same Business Trust unless a cool-off period of five years has elapsed from the date of completion of the term.

b. Limited Review of SPV/ Holdco Financial Statements

Auditors shall be required to mandatorily undertake a limited review of the audit of all entities or companies whose accounts are to be consolidated with the accounts of the Business Trust; (i.e. special purpose vehicles ("**SPV**") and Holdcos of the Business Trust), in accordance with the applicable Indian Accounting Standards. Therefore, additional protections have been built into the regulations, keeping in mind the interests of investors, to account for instances where the auditor of the Business Trust is different from the statutory auditor of one or more SPVs/ Holdcos. This may require existing and prospective Business Trusts, where the holding structures are serviced by multiple audit firms, to reassess their strategy, going forward.

2. Clarifications in relation to computation of debt leverage of Business Trusts

The consolidated borrowings and deferred payments of listed REITs and InvITs, net of cash and cash equivalents are prohibited from exceeding 49% and 70%, respectively, of the value of the Business Trust's assets.

Pursuant to the Amendments, it has been clarified that (i) investments by listed Business Trusts in overnight mutual funds, characterised by their investments in overnight securities, having a maturity of one day, shall be considered as cash and cash equivalent; and (ii) that the amount of cash and cash equivalent shall be excluded from calculating the value of the assets of Business Trust.

3. Requirement in relation to unclaimed or unpaid distributions

Any amount remaining unclaimed or unpaid out of the distributions declared by a Business Trust shall mandatorily have to be transferred to the SEBI-constituted 'Investor Protection and Education Fund'.

B. Changes proposed to be applicable with effect from April 1, 2023

In addition to the changes summarised above, the Amendments have also notified provisions that are proposed to be applicable from April 1, 2023. These fall under two categories: (i) the introduction of a new chapter, under both the InvIT and REIT Regulations, on the applicability of select provisions of the Listing Regulations to Business Trusts; and (ii) the introduction of, or amendment to, the definitions under the InvIT and REIT Regulations to, *inter alia*, facilitate the applicability of certain key concepts under the Listing Regulations, to Business Trusts. For the first category, the Amendments have also provided clarifications on how the requirements for the applicable provisions of the Listing Regulations will apply to Business Trusts, given their unique holding and management structures. In this regard, the Amendments have provided that defined terms under the Listing Regulations are to be substituted in the following manner for InvITs and REITs, respectively:

Term/ expression under the Listing Regulations	Substituted term/ expression under the InvIT Regulations	Substituted term/ expression under the REIT Regulations
Promoters	Parties to the InvIT (i.e. sponsor, investment manager, project manager and trustee)	Parties to the REIT (i.e. sponsor, sponsor group, manager and trustee)
Listed entity	InvIT or investment manager of the InvIT, as may be applicable	Manager of the REIT
Company secretary	Compliance officer	Compliance officer
Executive director	Non-independent director	Non-independent director
Non-executive director	Independent director	Independent director
Board of directors of the listed entity	Board of directors of the investment manager	Board of directors of the manager
Subsidiary of listed entity	Holdco and/ or SPV of the InvIT, as applicable	Holdco and/ or SPV of the REIT, as applicable

The key changes that are proposed to be applicable with effect from April 1, 2023, are as follows:

1. **Alignment of independent director related requirements in line with listed entities**

   a. Test of independence

   Presently, the InvIT and REIT Regulations only prescribe one test of independence – that the director should not be an independent director on the Board of the investment manager of another InvIT or REIT, as the case may be. Whilst most listed Business Trusts were, in any event, following a higher level of compliance with the governance framework, vis-a-vis independent directors by also testing, in spirit, their independence as per the tests prescribed under the Companies Act, 2013, and the Listing Regulations, the Amendments have now codified the tests for independence of directors on the Board of the investment manager of a Business Trust, in line with the Listing Regulations, by virtue of introducing the definition of 'independent director' in the respective regulations.

   Accordingly, any person proposed to be appointed as an independent director will necessarily have to meet the requirements of experience, expertise, absence of pecuniary relationships, pre-existing commercial arrangements or positions of conflicts and shareholdings, among others. As stated above, while most of these tests were in any case being applied to independent directors by most Business Trusts, the interesting tweak introduced by the Amendments is the scope of entities, which need to be assessed whilst applying the tests of independence.

Given that the ambit is proposed to cover holding companies, SPVs, sponsors (also sponsor groups for REITs), promoters of the parties to the Business Trust, promoters of the holding, subsidiary or associate companies of parties to the Business Trust, and in certain cases, even any company 'belonging to the parties to the Business Trust' or 'related persons', eligibility of independent directors will have to be determined on a case by case basis depending on the relevant facts.

b. Requirements in relation to appointment, re-appointment, removal, and tenure

Under Regulation 25(2A) of the Listing Regulations, appointment, re-appointment, or removal of an independent director of a listed entity requires shareholder approval by way of a special resolution. Where the requisite shareholder approval is not obtained, the resolution is deemed to be approved if the votes cast by public shareholders in favour of the resolution exceeds the votes cast against. Interestingly, whilst the Amendments clarify that a 'listed entity' is to be read as the manager of the Business Trust (or in the case of InvITs, the manager or the InvIT, as applicable – see table above), a similar clarification has not been provided for the usage of the term 'shareholders'.

Additionally, pursuant to the Amendments, it has been re-emphasised that the maximum tenure of independent directors even in case of Business Trusts shall be in accordance with the Companies Act, 2013.

c. Re-categorisation post-resignation

Pursuant to the Amendments, an independent director who resigns from the board of an investment manager shall not be eligible, for a period of one year post resignation, to be appointed as a non-independent director on the board of the investment manager, its holding companies or associate, the holding companies or SPVs of the Business Trust, or companies belonging to the promoter group of the investment manager.

d. Evaluation related provisions

Pursuant to the Amendments, independent directors will be required to hold at least one

meeting in a financial year, without the presence of non-independent directors and members of the management, and all independent directors shall strive to be present in such meetings. During the meeting, independent directors shall be required to, *inter alia*, review the performance of non-independent directors and the board as a whole – review the performance of the chairperson, assess the quality, quantity and timeliness of flow of information between the management and the board, so as to enable the board to reasonably perform its duties.

e. Provisions for the protection of independent directors

Presently, there are no explicit provisions under the REIT and InvIT Regulations, which set out the protections available to independent directors acting in their professional capacities. However, with effect from April 1, 2023, two key changes will come into force, and independent directors will have the benefit of: (i) Regulation 25(5) of the Listing Regulations, which clarifies that independent directors shall be held liable only for acts of omission or commission occurring with their knowledge, consent or connivance, or where the director has not acted diligently; and (ii) Regulation 25(10) of the Listing Regulations, which requires directors and officers insurance to be undertaken for all independent directors of the top 1000 listed entities by market capitalisation.

2. Alignment of board composition, quorum and committee constitution requirements with listed companies

a. Requirements in relation to board composition, quorum and frequency of meetings

Presently, the only requirement applicable to investment managers on board composition under the relevant regulation is that half the board should be independent. However, pursuant to the Amendments, with effect from April 1, 2023, the board of an investment manager is required to have: (i) at least six directors; and (ii) at least one woman independent director. Interestingly, there are no thresholds prescribed under the Amendments for these requirements, and as such every investment manager of a listed Business Trust will be expected to take the requirements into account.

The Amendments also introduce requirements in relation to quorum and frequency of meetings. Every board meeting will require the presence of: (i) at least one third of the total strength or three directors (whichever is higher); and (ii) at least one independent director. The board is also required to meet at least four times a year, with a maximum time gap of 120 days between any two meetings. It may be pertinent to add here that most Business Trusts have been, as a matter of good governance, following these requirements even before the introduction of the Amendments.

b. Minimum information to be placed before the board

In a welcome move, the Amendments have introduced detailed schedules in both the InvIT and REIT Regulations on minimum information to be placed before the board of directors of the investment manager. The list of information required, which is aligned with the provisions applicable to listed companies, is fairly detailed, and covers several key heads such as budget and operating plans, overview of meetings and financial performance, information on recruitment and remuneration of senior officers, information on accidents and regulatory actions, defaults in financial obligations, liability claims, material sales of investments, among others. Key information on several aspects is required to be presented before the board, not just related to the Business Trust, but also the underlying holding companies and SPVs.

c. Committee related requirements

Whilst the constitution of committees by investment managers of business trusts has typically been guided by good governance and global best practices, following the Amendments, the constitution of the following committees has been made mandatory for Business Trusts: (i) audit committee; (ii) nomination and remuneration committee; (iii) stakeholders relationship committee; and (iv) risk management committee. Needless to add, the requirements in relation to the composition, quorum, and frequency of meetings for these committees, as prescribed under the Listing Regulations for listed entities, will also apply to the committees constituted by Investment Managers. Additionally, pursuant to the Amendments, the role and scope of activities of these committees will be required to be guided by the terms of reference set out under Schedule II of the Listing Regulations.

d. Restriction on maximum number of committee memberships

Under the Listing Regulations, a director is not permitted to be a member of more than 10 committees or act as chairperson of more than five committees across all listed entities in which he or she is a director, provided that the limit does not take into consideration: (i) private companies, foreign companies, high value debt listed entities or companies under Section 8 of the Companies Act, 2013; or (ii) chairpersonship or membership of any committee other than audit committee or stakeholders' relationship committee. Pursuant to the Amendments, this requirement has been made applicable to Business Trusts as well. However, given the clarifications issued under the Amendments regarding the substitution of defined terms, specifically, 'listed entities', further clarity may be required on the manner in which this is to be implemented for Business Trusts.

3. **A robust governance framework for Business Trusts**

a. Vigil mechanism and whistle-blower policy

Investment managers will now be required to formulate vigil mechanisms, including a whistle-blower policy, for directors and employees to report genuine concerns. The Amendments also provide that the audit committee shall review the functioning of the vigil mechanism, and that an independent service provider, which shall report to the audit committee, may be engaged for providing or operating the mechanism.

b. Additional reporting requirements

The Amendments have introduced a slew of reporting requirements, both internal and external, which Business Trusts will be required to follow. The Board will be required to review quarterly compliance reports in relation to all laws applicable to InvITs or REITs, as the case may be. Further, the compliance officer, CEO and CFO will be required to provide compliance certificates to the Board in relation to their review of financial statements, transactions entered into by the manager, and steps taken by them in relation to internal controls over financial reporting. Additionally, the investment manager will be required to submit: (i) secretarial compliance reports annually, as an annexure to the annual report of the Business Trust; and (ii) quarterly compliance reports on governance within 21 days from the end of each quarter.

c. Compensation or profit-sharing arrangements

Another key provision of the Listing Regulations, which will become applicable to Business Trusts with effect from April 1, 2023, is the restriction on employees, including key managerial personnel or directors or promoters of listed entities, from entering into any agreements pertaining to compensation or profit sharing in connection with dealings in the securities of such listed entity, unless prior board and public shareholder approval is obtained. Whilst upside arrangements have been tested extensively in the listed company space, the typical holding and governance structures of Business Trusts, as well as the guidance already provided under the Amendments vis-à-vis the interpretation of 'listed entity', the application of this provision on future and existing arrangements will require deeper thought and analysis.

Conclusion

Whilst the Listing Regulations have evolved considerably since their notification in 2015, integrating the nuances of the Business Trust holding and governance structure into the pre-existing regulations originally conceived for listed companies may have posed practical challenges. Whilst most listed Business Trusts in India have strived to adopt global best practices and implement the spirit of the Listing Regulations all along, the specific provisions notified pursuant to the Amendments mark a step in the right direction for the evolution of the regulatory regimes governing InvITs and REITs.

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