

February 2023



Governance Norms Notified for REITs and InvITs

Background

On February 14, 2023, the Securities and Exchange Board of India (“SEBI”) has notified amendments (the “**2023 Amendments**”) to the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014 (the “**REIT Regulations**”) and the Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014 (the “**InvIT Regulations**”), which codify the governance norms applicable to real estate investment trusts (“**REITs**”) and Infrastructure Investment Trusts (“**InvITs**”) (REITs and InvITs together as “**Investment Trusts**”)

Prior to the 2023 Amendments, the REIT Regulations and the InvIT Regulations prescribed certain limited governance requirements, including 50% of the board of directors of the investment manager of an InvIT/manager of a REIT (“**Board**”) being independent and appointment of a compliance officer, however the applicability of governance norms provided under the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (“**LODR Regulations**”) on Investment Trusts was not clear. Due to lack of clarity, some of the Investment Trusts were voluntarily complying with the governance norms provided under the LODR Regulations as a good governance measure, however, the practice was not uniform. Further, on January 17, 2023, the LODR Regulations were amended to clarify that the governance norms provided under the LODR Regulations will not be applicable to Investment Trusts. The 2023 Amendments now provide clarity on the

applicability of governance norms under the LODR Regulations to Investment Trusts.

Key Changes and Implications

The changes provided under the 2023 Amendments are applicable with effect from the date of publication (i.e. February 14, 2023), whereas certain amendments are applicable with effect from April 1, 2023.

Key Changes with effect from April 1, 2023

Independent Directors

Investment Trusts have an obligation to ensure that 50% of the Board is constituted of independent directors. However, prior to the 2023 Regulations, the REIT Regulations and InvIT Regulations did not provide a definition or any criteria for a director to qualify as an ‘independent director’.

While, listed Investment Trusts were voluntarily adopting the tests for independence under the LODR Regulations as a guiding criteria - the 2023 Amendments have included a definition of ‘independent director’ and aligned the tests of independence for Investment Trusts with the LODR Regulations.

The following are some key considerations:

- Independent directors will be required to satisfy independence tests such as demonstrating no conflict of interest or pecuniary relationships and requisite expertise to act as an independent director.
- The independence tests will need to be tested at various levels, including the Investment Trust, the Holdco/SPV and the

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parties to the Investment Trusts (and its holding company, subsidiary or associate or their promoters or directors). Given that the parties to the Investment Trust include sponsor(s), sponsor group (applicable only to a REIT), trustee, investment manager/manager, trustee and project manager (applicable only to an InvIT), the independence tests for Investment Trusts are more expansive than those applicable to listed companies.

- Parties to the Investment Trusts also include the 'trustee' of the Investment Trust, which is typically an institutional trustee. Since, the REIT Regulations and InvIT Regulations require a trustee to be an independent entity (not related to the sponsor(s) and the investment manager/manager), it will be critical to check the independence criteria from a trustee perspective, given that some of the independence criteria will *need to be tested at the level of the holding company and associates (in case of certain tests) of the trustee.*

Applicability of Certain Provisions of the LODR Regulations to Investment Trusts

The 2023 Amendments have made certain provisions of the LODR Regulations applicable to Investment Trusts. However, the 2023 Amendments have clarified the following substituted terminology for interpreting the provisions under the LODR Regulations in the context of Investment Trusts.

Term under the LODR Regulations	Substituted terminology
Promoters	Sponsor(s), sponsor group (applicable only to a REIT), trustee, investment manager/manager, trustee and project manager (applicable only to an InvIT)
Listed entity	InvIT or investment manager of the InvIT/manager of the REIT
Company secretary	Compliance officer
Executive director	Non-independent director
Non-executive director	Independent director
Board of directors of the listed entity	Board of directors of the investment manager of the InvIT/manager of the REIT
Subsidiary of listed entity	Holdco and/or SPV of InvIT/REIT

It may be noted that while the definition of 'listed entity' in the context of an InvIT includes an InvIT or the investment manager, the definition of 'listed entity' in the context of a REIT only includes a 'manager of the REIT'. This will require further clarification, especially with respect to certain provisions of LODR Regulations, now made applicable to Investment Trusts, which are applicable to any 'listed entity'.

The following are some of the key implications of applicability of certain provisions of the LODR Regulations to Investment Trusts:

Committees Related:

Pursuant to the 2023 Amendments, the board of directors of the investment manager/managers of Investment Trusts are required to constitute (a) audit committee, (b) nomination and remuneration committee, (c) stakeholders relationship committee; and (d) risk management committee. Prior to the 2023 Amendments, some of the Investment Trusts had voluntarily constituted the aforementioned committees as a measure of good governance, however, the practice was not consistent. As a result of the changes introduced by the 2023 Amendments, other provisions of the LODR Regulations in relation to constitution, quorum, frequency of meeting, and the role of such committees shall also be applicable to Investment Trusts.

Independent Director Related:

- Tenure, appointment and removal**
The maximum tenure of an independent director on the board of directors of the investment manager/manager will be in accordance with the Companies Act, 2013 i.e. up to a term of 5 years, which can be further extended to another term of 5 years.

Further, the appointment, re-appointment and removal of independent directors will be by way of a special resolution. Based on the language of the agenda of SEBI's board meeting, it is apparent that a special resolution passed by the shareholders of the investment manager/manager will be sufficient for the

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appointment, re-appointment or removal of the independent directors. Further, the proviso to regulation 25(2A) of the LODR Regulations provides that the special resolution will be deemed approved, even though it fails to get the requisite majority of votes, if (i) the votes cast in favour of the resolution exceed the votes cast against the resolution and (ii) the votes cast by the public shareholders in favour of the resolution exceed the votes cast against the resolution.

- **Meeting of Independent directors**
Independent directors will be required to hold atleast one meeting in a financial year, without the presence of independent directors and members of the management to, among other things, review the performance of non-independent directors and the board of directors of the investment manager/manager as a whole.
- **Liability of independent directors**
The independent directors will be held liable only for acts or omissions which had occurred with their knowledge and with their consent or connivance or where such independent director had not acted diligently. The investment manager/manager will also be required to obtain a directors and officers insurance for the independent directors.

Director, KMP, Senior Management and Employee Related:

- **Restriction on committee membership**
A director of a listed company is not allowed to be a member of more than 10 committees or be a chairperson of more than 5 committees across all listed entities in which he or she is a director. The limit on committees has certain exclusions such as private limited companies, foreign companies, high value debt listed companies and companies under Section 8 of the Companies Act, 2013. Chairpersonship or membership of any committee other than audit committee or stakeholders' relationship committee is also excluded. It may be noted that SEBI, in its board

meeting agenda, had provided that these limits were applicable only for 'equity listed entities' and that such requirements will be automatically applicable if the equity shares of the investment manager/manager are listed. However, given that the investment manager/manager are typically unlisted entities, there is further clarity required for the applicability of this requirement on the directors of the investment manager/manager.

- **Profit sharing arrangements**
One of the key changes under the 2023 Amendments is the applicability of Regulation 26 of the LODR Regulations to Investment Trusts. Pursuant to Regulation 26 of the LODR Regulations, members of the senior management are required to disclose all material, financial and commercial transactions where they may have a personal interest that may have a potential conflict with the interest of the listed entity at large. Conflict of interest relates to dealing in the shares of the listed entity, and commercial dealings with bodies which have shareholding of management and their relatives.

Further, no employee (including key managerial personnel) or director of the investment manager or any of the parties to the Investment Trust, is permitted to enter into any agreement for itself or on behalf of any other person with any shareholder or any other third party with regard to compensation or profit sharing in connection with dealings in the securities of the listed entity, unless prior approval of the board and the public shareholders has been obtained by way of an ordinary resolution.

However, given that the term 'listed entity' is defined to also include the investment manager of an InvIT under the InvIT Regulations, but only manager of a REIT under the REIT Regulations, the applicability of this provision will require further clarification and analysis.

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Client Update

Board Composition, Quorum and Meetings

Prior to the 2023 Amendment, the REIT Regulations and the InvIT Regulations only required 50% of the board of directors of the investment manager/manager to be independent. Pursuant to the 2023 Amendments, the investment manager/manager is required to comply with the following conditions:

- The board should consist of at least six directors, which shall include at least one woman independent director;
- Quorum for the board meetings shall be one-third of its total strength or three directors, whichever is higher, with the mandatory presence of at least one independent director; and
- Minimum information to be placed before the board, including, among others, annual operating plans and budgets, capital budgets, quarterly results for the investment manager and its operating divisions, show cause notices (which are materially important).

Compliance Requirements

The 2023 Amendments have introduced additional compliance requirements, which include (i) compliance report for review of compliance with laws applicable to Investment Trusts and steps taken to rectify this, (ii) secretarial compliance report issued by a practicing company secretary in specified format is required to be submitted to the stock exchanges on an annual basis, within 60 days of the end of the financial year; (iii) corporate governance compliance report in the specified format to be submitted to the stock exchanges on a quarterly basis, within 21 days of the end of each quarter; and (iv) compliance certificate to be issued by the chief executive officer, chief financial officer and compliance officer to the board of the investment manager/manager in relation to the financial statements of the Investment Trusts and internal controls.

Vigil Mechanism

The investment manager/manager is required to formulate a vigil mechanism, including a whistleblower policy for directors and employees to report genuine concerns. The

functioning of the vigil mechanism is required to be reviewed by the audit committee.

Key Changes with effect from date of notification (February 14, 2023)

Appointment of Auditors

The 2023 Amendments have aligned the audit framework of Investment Trusts with listed companies. The following are the key changes:

- appointment of an individual or a firm as statutory auditors for a term of five years;
- term of individual auditor will be 5 consecutive years, whereas term for audit firm will be two terms of five consecutive years (“Term”); and
- cooling-off period of five after completion of Term.

Limited Review of SPV/Holdco’s

It is not unusual for SPVs/Holdco’s to have different auditors than the Investment Trusts. However, prior to the 2023 Amendments, there was no obligation on the statutory auditor of the Investment Trusts to undertake a limited review of the financials of the SPVs/Holdco’s. Pursuant to the 2023 Amendments, the statutory auditor is required to undertake a limited review of the accounts of all entities whose accounts are consolidated with the accounts of the Investment Trusts, in accordance with applicable accounting standards.

Leverage Calculation

The consolidated borrowings and deferred payments, net of cash and cash equivalents, are not permitted to exceed 70% for InvITs and 49% for REITs, subject to certain conditions.

For purposes of calculation of these thresholds, the 2023 Amendments clarify that (i) overnight mutual funds, characterized by their investments in overnight securities and having maturity of one day, will be considered cash and cash equivalents; and (ii) the amounts of cash and cash equivalents is required to be excluded from the calculation of the value of the InvIT/REIT assets.

Change in Control

Prior to the 2023 Amendments, the definition of ‘change in control’ under the REIT Regulations

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and the InvIT Regulations (i) in relation to bodies corporate (which includes a company) referred to the definition of control under the Companies Act, 2013 and (ii) in relation to entities other than bodies corporate, referred to a change in the 'controlling interest' of the entity, with 'controlling interest' defined as a direct or indirect interest to the extent of more than 50% of voting rights or interest in such entity.

SEBI in its Board meeting agenda recognised that the definition of 'change in control' is not a 'one-size-fits-all' definition, since the definition of 'change in control' applicable to listed companies may not be applicable to the sponsor, the investment manager/manger or the trustee. For instance, the trustee being a SEBI registered debenture trustee, 'change of control' for a trustee will be governed by the Securities and Exchange Board of India (Debenture Trustees) Regulations, 1993 ("**Debenture Trustee Regulations**").

In light of the above, 2023 Amendments amend the "change in control" under the REIT Regulations and InvIT Regulations to mean (i) in case of a listed body corporate, definition of control under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011 and

(ii) in case of an unlisted body corporate, the definition of control under the Companies Act. For entities other than bodies corporate, change in control has been defined to mean a change in its legal formation, ownership or controlling interest.

SAM's Insight

A robust governance framework is essential for all listed entities. Given the increased participation by global sovereign wealth funds and private equity investors in REITs and InvITs, the 2023 Amendments are a welcome move, which will ensure that the governance framework for Investment Trusts is at par with listed companies. However, the 2023 Amendments require further clarity on certain issues, especially the definition of 'listed entities' in the context of REITs. Further, existing Investment Trusts will be required to comply with independence tests with respect to the enhanced scope provided under the 2023 Amendments and, in certain cases, may require certain structural changes to incorporate the new governance regime. However, we believe the amendments and changes are a step in the right direction and will greatly benefit the maturing Investment Trusts market and strengthen the positioning of Investment Trusts as an alternate and growing asset class for investors.

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