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Analysing developments impacting business

SEBI MOVES TO FILL IN A VOID WITH CODIFICATION OF CORPORATE GOVERNANCE MEASURES FOR INVITS AND REITS

6 March 2023 **Background**

While the SEBI (Real Estate Investment Trusts) Regulations, 2014 (**REIT Regulations**) and SEBI (Infrastructure Investment Trusts) Regulations, 2014 (**InvIT Regulations**) prescribed certain corporate governance requirements such as independence of at least half of the board of directors of the investment manager of Infrastructure Investment Trusts (**InvITs**) and Real Estate Investment Trusts (**REITs, together with InvITs, referred to as the Trusts**), etc., there was a lacuna in the absence of a codified corporate governance framework applicable to Trusts. Up until now, Trusts have had voluntary adherence to certain governance measures borrowed from the governance framework applicable to equity listed companies, however, this was not uniformly implemented and therefore a need for codification was imminent.

To this end, SEBI vide its notification dated 17 January 2023 amended the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (**Listing Regulations**) to exclude the limited applicability of certain specific provisions of the Listing Regulations to Trusts which had issued 'high value debt securities' and vide amendments to the InvIT Regulations and the REIT Regulations on 14 February 2023 (**Amendment**) notified a robust framework of governance measures to be followed by the Trusts.

Key changes brought about by the Amendment

- Definition of 'change in control': Since the scope of the term 'change in control' under the InvIT Regulations and the REIT Regulations had limited coverage, SEBI has sought to bring about a harmonised definition of the term 'change in control' to separately cover (a) listed companies and listed body corporates and link it to the definition of the term 'control' under the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011; (b) unlisted companies or unlisted body corporates and link it to the definition of the term 'control' under the Companies Act, 2013; and (c) for entities other than body corporates, the scope of the term has been widened to include change in its legal formation or ownership or change in the controlling interest of not less than 50% voting rights or interest. The Amendment seeks to extend the coverage of 'change in control' to cover entities such as the trustee of the Trusts, the sponsors of the Trusts, etc., which maybe unlisted entities or entities other than a body corporate.
- Independent directors: While the InvIT Regulations and REIT Regulations did not include a codified definition of 'independent directors', the current framework required at least half of the board of directors (governing board in case of a LLP) of the investment manager to comprise of independent members. The Amendment has now

codified the criteria for an 'independent director' under the InvIT Regulations and the REIT Regulations and has aligned it with the Listing Regulations.

- Senior management: A new concept of 'senior management' has been introduced in the InvIT Regulations and REIT Regulations with a view to align the term with the Listing Regulations. Senior management are defined to include officers and personnel of the investment manager, who are part of its core management (excluding board of directors), and also the members of the management, who are one level below the chief executive officer or managing director or whole time director along with the company secretary and chief financial officer. It is pertinent to note that while the existing InvIT Regulations and REIT Regulations do not prescribe any rights, obligations, or disclosures for the entities falling within the gamut of 'senior management', the Amendment has made certain provisions of the Listing Regulations requirements pertaining to senior management applicable to Trusts as well. SEBI's intention with the introduction of the concept of senior management is to achieve a greater degree of transparency and insight by providing for a succession plan of senior management, laying down a code of conduct for them and disclosure of all material, financial and commercial transactions of such senior management to the board of directors of the investment manager.

Note: This portion of the amendment is proposed to be made applicable with effect from 1 April 2023.

- Limited review of consolidated entities by Trust's auditor: Under the current legal framework, the auditor of the Trust is required to undertake the audit or limited review of the financials of the Trust. However, the extant InvIT Regulations and REIT Regulations did not mandate that the auditor of the Trust will be required to conduct procedures on the financials of the entities being consolidated or combined with the financials of the Trust. Therefore, to provide a greater degree of assurance on the disclosures being provided by the Trust, the auditor of the Trust is now being required to undertake a limited review of the audit of all entities whose accounts are being consolidated with the accounts of the Trust as per the applicable Indian Accounting Standards.

This requirement is also applicable to listed companies under the Listing Regulations. SEBI has issued a circular no. CIR/CFD/CMD1/44/2019 dated 29 March 2019 ("**Circular**") which *inter alia*, prescribed the procedure to be carried out for compliance of this requirement. Although SEBI has not specifically said that the Circular would be applicable to the Trusts also, however, we believe that the Trusts and their auditors can take guidance from the Circular and apply the same procedure.

- Calculation of leverage threshold: Under the present framework, the aggregate consolidated borrowings and deferred payments of the Trust, the holding company and/or the special purpose vehicles, net of cash and cash equivalents is required to not exceed 49% (in case of REITs) and 70% (in case of InvITs) of the assets of the Trust. Basis feedback from market participants, SEBI has clarified that temporary liquid investments will form part of the 'cash and cash equivalents' instead of 'current investments'. Accordingly, for the purpose of computation of leverage, the Amendment has classified investments in overnight mutual funds, characterized by their investments in overnight securities and having maturity of one day as forming part of cash and cash equivalents. Further, the cash and cash equivalents that has been deducted from the consolidated borrowings and deferred payments in order to compute total consolidated borrowings is required to be excluded from the calculation of the value of the Trust's assets.

Since the Amendment now requires the cash and cash equivalents to be reduced not just from debt but also the Trusts' total assets, the computation of leverage ratio for

Trusts may need to be re-evaluated and components may need to be readjusted such that the overall leverage does not get reduced.

- Appointment of auditor and cooling off period: To clarify the start and end of the mandated five year period for which an auditor could be appointed, to avoid cases where the Trust have been established much before the initial offering being undertaken, the Amendment has now clarified that the investment manager of the Trust shall appoint an auditor for the Trust for a period of five years which shall end upon the conclusion of the sixth annual general meeting of the unitholders. Such auditor, if an individual, shall not be re-appointed post completion of one term of five years, whereas in the case of a firm of auditors, shall not be re-appointed post completion of two term of five years. Additionally, a cooling off period of five years have been notified, post which such auditors shall again become eligible for fresh appointments. These changes are in line with the requirements applicable to listed companies.
- Obligations of the Investment Manager: Certain corporate governance requirements under the Listing Regulations have been made applicable to the Trusts, with the requisite customisations for such Trusts. These *inter alia* include (i) laying down certain procedures and codes by the board of the investment manager; (ii) setting up of various committees of the investment manager; and (iii) obligations with respect to independent directors and obligations with respect to employees including senior management, key managerial personnel, directors and promoters. Further, additional requirements include the (i) board of the investment manager to comprise of minimum 6 directors with atleast 1 woman independent director; (ii) quorum for board meetings to be 1/3rd or three directors, whichever is higher, with at least one independent director being present; (iii) review by board of the compliance report every quarter; (iv) chief executive officer, chief financial officer and compliance officer to provide a periodic compliance certificate; (v) establishment of a vigil mechanism including whistle blower policy for directors and employees to report genuine concerns; and (vi) submission of secretarial compliance report annually and compliance report on governance by the investment manager on a quarterly basis to the stock exchanges within prescribed timelines. Certain minimum information that needs to be placed before the board of the Investment Manager has also been notified in the Amendment.

Note: This portion of the amendment is proposed to be made applicable with effect from 1 April 2023.

Remarks

The Amendment brings about a welcome change to address the needs of the Trust, which considering their structure are inherently different from that of a company, and since the Trusts are managed by another entity, the interplay of relationships between the unitholders, the board of director of the investment manager and other stakeholders, required a separate codified corporate governance framework, other than that prescribed under the SEBI Listing Regulations. Whilst in the past, some of the Trusts have strived to adopt best practices and follow the Listing Regulations, the specific provisions notified pursuant to the Amendment shall go a long way to streamline the corporate governance framework and safeguard the interest of unitholders of the Trust, by enhancing the core committees of the Board, enhancing the disclosure norms amongst other aspects.

- Sudhir Bassi (Executive Director), Aayush Mohata (Partner), Aparna Bagree (Principal Associate) and Adrika Dhawan (Associate)

For any queries please contact: editors@khaitanco.com

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