

# Governance arrangements in Infrastructure Investment Trusts – First steps on the path to certainty?

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Infrastructure investment trusts (InvITs) have gained popularity in recent years as a vehicle for infrastructure investments, with project developers, private equity firms, pension funds and sovereign wealth funds looking to boost yields and access liquidity. An InvIT is structured as a trust (which receives investments), and is managed by an 'investment manager', which is a separate company (where management control of the trust is vested).

Considering the capital-intensive nature of infrastructure investments, several co-investment structures consisting of strategic sponsors (such as developers and private equity funds) and long-term financial co-investors (such as sovereign wealth funds and international pension funds) have taken root amongst InvITs, across sectors ranging from highway assets to renewable energy.

Designing an appropriate governance and economic framework for such co-investments presents unique challenges, primarily due to the bifurcated legal structure of InvITs and a reluctance on the part of the Securities and Exchange Board of India (SEBI) to permit 'special rights' for unitholders holding a significant stake (current SEBI regulations require all unitholders in an InvIT to have equal rights).

Recently, SEBI decided to provide minority unitholders in InvITs with statutory governance rights in the form of representation on the board of directors of investment managers. This article discusses the key issues arising out of SEBI's decision and suggests some potential solutions.

## 1 Background

Until a few years ago, it was common practice for unitholders of InvITs holding significant positions to be granted the right to nominate directors to the boards of investment managers, with such rights being incorporated in the governing documents of the InvIT and the investment manager entity. However, SEBI's concern - that such an arrangement would violate the regulatory bar on 'special rights' for unitholders - has led to the current practice of co-investors with significant positions in an InvIT picking up a corresponding equity stake in the investment manager, in connection with which they obtain governance rights such as board representation and reserved matters.

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Permissibility of governance arrangements amongst sponsors and significant unitholders in Infrastructure Investment Trusts has been debated for several years. SEBI has now proposed a codified mechanism for board representation on investment managers for minority unitholders. This article analyses the implications and takeaways of SEBI's proposal.

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Although SEBI has not publicly expressed a view on the permissibility of such arrangements, sponsors and co-investors argue that governance rights in such arrangements are granted in lieu of a separate investment in the investment manager and therefore do not constitute '*special rights*' for co-investors in their capacity as unitholders.

## 2 SEBI's recent proposals regarding minority unitholders' governance rights in InvITs

On 16 May 2023, SEBI released a consultation paper (**SEBI Consultation Paper**) on special rights for unitholders, and the role of InvIT sponsors, in which it mooted the possibility of codifying the rights of unitholders to participate in the governance of InvITs. The SEBI Consultation Paper proposed two options in this regard:

### a. *Option A: Nomination of unitholders to the board of the investment manager*

First, SEBI had suggested that unitholders holding at least 10% of the units of an InvIT (either individually or collectively) could have the right to nominate one director to the board of the investment manager for each block of 10% units that they hold.

### b. *Option B: Establishment of unitholder councils*

As an alternative to representation on the investment manager's board, the SEBI Consultation Paper had also mooted the idea of a '*unitholder council*' as an additional decision-making body on strategic matters impacting the InvIT. Under SEBI's proposal, unitholders holding at least 10% of the InvIT units would have the right to nominate one member to the council, and each decision of the board of the investment manager would be subject to an additional vote of the unitholders' council.

Subsequently, SEBI, in its board meeting of 28 June 2023, approved the proposal to provide unitholders holding at least 10% of the units of an InvIT with director nomination rights (i.e., Option A above).

## 3 Key implications of SEBI's proposal

### 3.1 Interplay with contractual arrangements at Investment Manager

Current governance arrangements at investment managers often include board seats for significant financial investors, which are pegged to identified shareholding thresholds. The interplay between SEBI's proposal (i.e., board seats for >10% unitholders coupled with the current requirement for 50% independent directors) and such commercially negotiated arrangements would need to be clarified. Specifically, if SEBI intends that the regulatory stipulation serve as a complete code, such that the constitution of the boards of investment managers would be governed solely under SEBI's regulations, financial investors and sponsors may be precluded from negotiating additional board seats based on a separate investment in the investment manager, based on commercially agreed shareholding thresholds.

Further, financial co-investors with a significant stake in an InvIT would, in addition to a board seat, ordinarily expect veto rights on matters such as material future acquisitions/disposals, debt financing terms and senior management appointments and incentive terms, etc.

The SEBI Consultation Paper and board meeting minutes do not specifically address the question of whether unitholders may still obtain veto rights at the investment manager on a contractual basis, in connection with a separate stake in the investment manager (in line with current practice). It remains to be seen if SEBI addresses this aspect, as SEBI has so far not clarified if governance rights obtained in connection with a

separate stake in the investment manager amount to special rights for unitholders. With the introduction of a new regime under which SEBI has, for the first time, granted statutory governance rights for minority unitholders in the form of board representation, it is possible that SEBI may view 'additional' governance rights (such as veto rights) for certain unitholders (even if they are technically obtained in connection with a separate investment in the investment manager) as going contrary to the principle of parity amongst unitholders.

In the absence of such veto rights, co-investors would need to rely on the requirement to obtain unitholder approval under the InvIT Regulations, which only applies to transactions meeting specified thresholds. For instance, related party transactions require unitholder approval only after the initial public offer of the InvIT and only if the value of any sale or acquisition of assets or securities to or from related parties exceeds 5% of the value of the InvIT.

### 3.2 Large boards

In the SEBI Consultation Paper, SEBI had noted that its proposal could lead to the possibility of a large and dispersed board with potentially 20 members (ten unitholder nominees and ten independent directors, to meet the regulatory requirement that at least 50% of the directors of an investment manager must be independent directors).

While SEBI has not addressed this issue specifically in its board meeting, potential solutions could include:

- *Reduction of independent directors in broad-based InvITs:* The requirement that the boards of investment managers comprise at least 50% independent directors was introduced to serve as a counterbalance to unchecked sponsor influence and prevent abuse of the minority. With the proposal to provide direct representation to minority unitholders on the board of the investment manager, there may be scope for SEBI to scale back the requirement for 50% independent directors in InvITs with a broad-based unitholding, since there would be scope for significant minority representation (and correspondingly lesser sponsor representation) on the board of the investment manager. Alternatively, SEBI could clarify that nominees of minority unitholders who hold less than a stipulated unitholding would be considered as 'independent directors' for the purposes of regulations, subject to the absence of any other arrangements between the relevant unitholder and the InvIT/sponsor group.
- *Reduced board representation for sponsors with significant holdings:* For InvITs which have significant sponsor holdings, capping the sponsor's representation on the board once nominees of the sponsor constitute a majority of non-independent directors would serve to mitigate the concern regarding unwieldy boards.

### 3.3 Grandfathering of existing investment and governance arrangements

While the SEBI Consultation Paper does allude to the current practice of co-investors obtaining board representation in the investment manager under a separate investment, SEBI, in its board meeting, has not commented on whether such arrangements would be grandfathered under the proposed new regime or would need to be unwound on the basis that the new regime would function as a complete code with respect to board composition of investment managers. If SEBI adopts the latter position, financial investors who currently have equity positions in investment managers (with corresponding governance rights) would need to contend with a governance package that is limited to minority board representation, which could be more bare bone than their current governance arrangements.

### 3.4 Introduction of a stewardship code – a step towards unitholder fiduciary duties?

The SEBI Consultation Paper also proposed the introduction of a '*stewardship code*', which would be applicable to all unitholders who have representation on the board of the investment manager. This proposal was approved by SEBI in its board meeting of 28 June 2023.

The stewardship code would require unitholders to, among other things, act in the best interests of the InvIT and its unitholders as a whole, formulate a policy on management of conflicts of interest, and adopt policies on voting and collaboration with other large institutional investors to preserve the interests of other unitholders.

Traditionally, unitholders other than the sponsor would not occupy a fiduciary role towards the InvIT or other unitholders. Under the proposed stewardship code, unitholders with representation on the board of the investment manager may effectively be subject to fiduciary duties towards the InvIT and its other unitholders. In particular, this would assume significance for matters where there is a potential misalignment of interest between unitholders, such as asset acquisitions from the sponsor group or another significant unitholder, capital raises (where financial investors and private equity sponsors may prefer private investments in public equity (PIPE) as opposed to rights issuances to all unitholders) and distribution policies.

## 4 Conclusion

SEBI's decision opens the door for legitimising unitholder participation in the management of InvITs, which has long been a pressing issue for sponsors and investors accessing this key route for investments in infrastructure. However, SEBI's proposed approach also gives rise to a few questions, including the treatment of existing governance structures and whether sponsors and investors would now be precluded from privately negotiating additional governance arrangements. These aspects would need to be clarified before a definitive assessment can be passed by stakeholders.

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