The September Reforms – Decoding changes to the FDI policy

Introduction

On September 20, 2012, the Department of Industrial Policy and Promotion ("**DIPP**") of the Ministry of Commerce and Industry introduced the much-awaited and significant economic reforms in various sectors, and increased the cap on foreign direct investment ("**FDI**") in certain industries. These reforms extend to the retail, broadcasting, power and the domestic aviation sectors. The government hopes that this round of further liberalization will give a fillip to the economy, attract further FDI in the country and, eventually generate further employment in those areas. This newsletter discusses the series of the important initiatives announced in September with a particular focus on the retail sector.

1. Aviation and power[1]

Until the recent announcements, foreign airlines could participate in the equity of companies operating cargo airlines, helicopter and seaplane services, but not in Indian companies that were operating scheduled and non-scheduled air transport services. The position has now changed and foreign investors can now invest up to 49%, subject to certain conditions enumerated below, in such companies upon seeking the prior approval of the Foreign Investment Promotion Board, i.e., FIPB. It is noteworthy that the percentage includes both FDI and FIIs. Therefore, companies who operate scheduled air transport services (which include domestic scheduled passenger airlines) will have to really evaluate the precise levels as there is substantial FII holding in aviation stocks.

Now, scheduled air transport services require a Scheduled Operator Permit which, in turn, is issued to a company which is registered in India, whose chairman and at least two-third of the Board constitution is of Indian citizens and the substantial ownership is vested with Indian nationals. Evidently, the government has imposed restrictions on foreign investors to directly participate in the day-to-day management of the Indian company. Furthermore, all foreign nationals likely to be associated with the Indian entity in which the investment is made and all technical equipment imported as a result of such investment must obtain necessary security clearance from the relevant authorities.

Clearly, liberalizing FDI regulations in the aviation sector is an attempt to assist domestic Indian carriers struggling for funds. Time will tell whether they will be successful.

The new FDI policy has now permitted up to 49% foreign investment in power exchanges, subject to FDI limit of 26% and FII limit of 23% of the paid-up capital. FII investments would be permitted under the automatic route while FDI would require a government approval route. However, FII purchase would be restricted to the secondary market where only traded power units can be sold. All non-resident investors/entities who

[1] DIPP's Press Note 6 of 2012 contains the changes made to the FDI policy in aviation while Press Note 8 of 2012 provides for FDI in power exchange

usually have economic interests in the power exchange will not be allowed to invest more than 5% equity in the power exchange companies.

2. Broadcasting[2]

DIPP has increased the FDI cap on various broadcasting carriages services. The increase in FDI limit will apply to Teleports, direct-to-home, HITS[3], MSOs[4] and mobile TV operators. Companies will be able to invest up to 49% automatically and beyond that, up to 74% will require a prior approval. FDI in broadcasting carriage services will only be allowed if the Indian investee company follows certain terms and conditions. These state that the key executives of the Indian company like the CEO, the chief officers responsible for technical network operations and security of the broadcast services must be Indian citizens. Further, the Board of the Indian company should consist of a majority of Indian citizens.

Another level of approvals will be required from Ministry of Information and Broadcasting involving security clearance of key personnel and effecting any change in its board of directors.

Additionally, since the broadcast carriage services require software and computer hardware which is technical in nature, companies will need to follow the infrastructure/network/software related requirements related to broadcasting of TV channels. The person handling lawful interceptors of services from his broadcast equipment must necessarily be an Indian national and the company must never transfer database of any person subscribing to its broadcasting services unless provided by law. In addition, the broadcast carriage services companies need to provide necessary mechanisms and training to authorized personnel for lawful interception of its services, facilitate the authorities regarding monitoring of its services and be ready to produce necessary reports or face inspection as per the requirement of the Government or Telecom Regulatory Authority of India.

The object of the DIPP for increasing the cap on broadcasting carriage services is to provide parity to the investment across different cable TV distribution platforms. This will also aid the attempt to digitalize the cable TV network in India as foreign investors should provide sufficient funds for the same.

3. Retail

FDI reforms in the retail sector are still facing stiff opposition from various factions. By virtue of Press Note 4 of 2012, the DIPP not only introduced FDI in single-brand retail but went a step further to include multi-brand retail as well. Below are certain important conditions that foreign investors need to follow.

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[2] Press Note 7 of 2012, issued by DIPP deals with the aspect of increase in cap on FDI in the broadcasting sector

[3] HITS is a downlinking, distribution and transmission system that enables all pay channels to be downlinked at a central facility and then again be uploaded by the HITS operator to its satellite

[4] MSOs downlink the signals uploaded by HITS

3.1 FDI in single-brand retail

(a) Prior FIPB Approval

Despite 100% FDI being permitted in the single-brand retail, DIPP has sought to control the influx of foreign retailers. Foreign investors need prior approval of the FIPB for investing and owing to the sensitivity of FDI in single-brand retail, another screening layer has been provided by authorizing DIPP to examine the application before it is sent to FIPB for approval. DIPP wants to be sure that the application conforms to the stated terms and conditions that foreign investors are required to follow.

(b) Only single-brand products to be sold

The products to be sold must be single-brand only and should have previously been sold under the same brand name overseas. This means that foreign investors will need to separately apply for approval for each of its other brands, even though one company might own an assortment of different brands.

(c) Sourcing of products

Prior to issue of Press Note 4 of 2012, foreign investors had to mandatorily source at least 30% of the value of the products from small-scale industries, village and cottage industries, artisans or craftsmen from India. This effectively meant that a substantial amount of raw materials had to be procured locally. However, DIPP has now relaxed this requirement. Foreign investors can choose the source for its 30% sourcing. This may include small, medium or large scale enterprises. The government has retained the aspect of sourcing from Indian enterprises. This may dissuade those investors with existing sourcing contracts with other foreign enterprises. Nonetheless, a key object in allowing up to 100% FDI in single-brand retail is to increase sourcing of goods from India.

3.2 FDI in multi-brand retail

(a) Permitted FDI and minimum level of investment

DIPP issued Press Note 5 of 2012 and ushered in FDI in multi-brand retail, but unlike FDI in single-brand retail, only 51% FDI is permitted in multi-brand retail with a similar approval to be issued by the FIPB. Foreign investors will have to invest at least $100 million and will necessarily have to invest 50% of this investment in "back-end infrastructure" within the first three years. Back end infrastructure investment includes investment made towards processing, manufacturing, distribution etcetera. Owing to its scale of investment it appears that DIPP wants to encourage only those foreign investors who have long term business plans in India.

(b) Sourcing of products

The rule of minimum 30% value of procurement of manufactured processed products purchased sourced from Indian small industries, which have a total investment in plant and machinery up to $1 million, shall apply. Therefore, it appears that at least 30% of the products to be sold will have to be sourced from small enterprises. This is in total contrast to the policy to be followed by foreign investors for FDI in single-brand retail. Foreign investors involved in multi-brand retail may find it challenging to identify the source(s) in accordance with this requirement.

(c) Sale through outlets

DIPP has provided that retail sales outlets must be set up only in cities which have a population of more than 1 million. This appears to be a strategy to assess the effects of FDI in multi-brand retail and protect the interest of small traders, retailers etcetera who are usually centered in smaller cities.

(d) Ultimate right to allow FDI in multi-brand retail with State Governments

Opening the market in this area sparked a fair amount of controversy which eventually led to the decision that it shall be the prerogative of the various State Governments to allow FDI or not. In other words, the State Governments are free to follow or discard the policy. The level of investment and the procedure for sourcing products in accordance with the abovementioned policy should in all probability depend upon supplies from various states. Until foreign investors are ensured fully of a constant source of supply, they will hesitate in investing in multi-brand retail. Therefore, to avoid any conflict, DIPP has left the decision to allow multi-brand retail upon State Governments.

Conclusion

The opening up of various sectors of the economy for FDI spells good news for an economy which has been experiencing the impact of a global downturn coupled with a multitude of domestic problems. It seems that the approach of the DIPP has been to open the doors to foreign investment but with local participation. There are creases in the policy but it is premature to jump to any conclusions. Hopefully, in the months to come any ambiguity will be slowly dispelled.

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