

Indian Defense: Impact of changed regulations

Introduction

Foreign Direct Investment or FDI means investment by a non-resident entity or person, who is resident outside India, in the capital of an Indian company. In recent years, foreign investors have raised numerous concerns on the low limits of foreign ownership and other restrictions imposed by the regulators in the highly sensitive defense sector. The latest investment framework is contained in the consolidated FDI policy of 2015 (“**FDI Policy**”) which was notified on May 12, 2015 and which contains the current policy regulating FDI in different sectors, including defense. The FDI Policy was amended in November 2015 through Press Note 12 of 2015 (“**PN 12**”) and this, amongst other areas, further liberalized the defense sector, amended the approval process, sectoral caps, and entry conditions associated therewith. However, the industry perception is that despite changes to the FDI regime, they are not sufficient to boost overseas investment in the domestic industry and more extensive measures are needed to develop a friendlier investment climate, said defense analysts and overseas defense company officials.

This newsletter provides a broad, high-level, overview of the current regulatory regime in defense and the impact of the enhanced foreign ownership to 49%.

1. The Regulatory Regime

FDI is subject to sectoral caps, entry conditions, kind of investment instrument, pricing guidelines, and other terms and conditions, some of which are covered in the following paragraphs.

1.1 *Automatic vs. Government routes, sectoral limits*

FDI is possible in permitted sectors through two entry routes *viz.* Automatic i.e. without prior Government approval and Government i.e. subject to prior Government approval. The nodal agency which grants permission for investment is the Foreign Investment Promotion Board (“**FIPB**”) along with approvals from Department of Economic Affairs, Ministry of Finance, Department of Industrial Policy and Promotion (“**DIPP**”), as the case may be. Foreign investment in defense is allowed up to 49% under the Automatic route and is subject to industrial license under Industries (Development & Regulation) Act. Investment above 49% is under the Government route where approvals are granted on a case-to-case basis, provided such investment gives access to modern and state-of-art technology in India. The 49% sectoral cap is composite and covers FDI, foreign institutional investors, portfolio, venture capital, non-resident Indian investments, and qualified foreign investment.

Any foreign investment in defense must comply with the entry conditions as provided under Paragraph 6.2.6.2 of the FDI Policy. Prior to PN 12, the FDI Policy provided restrictive conditions including on management structure, ownership, disclosures, and security procedures. PN 12 repeals these restrictions and simplifies the entry route compliances. For defense

manufacturing, a company must obtain an industrial license from DIPP¹ in consultation with Ministries of Defense and External Affairs. The DIPP list of items is exhaustive including a wide variety of defense equipment. However, all such items and services which are not specifically mentioned in the DIPP list² do not require industrial license. Further, dual-use items i.e. those which have a military as well as civilian application (unless specifically classified as defense items in the DIPP list) will also not require industrial licensing and will be considered open for FDI under the automatic route up to 100%. This is also the case for companies engaged in services such as software development, maintenance services, repair and overhaul, research & development and do not require any industrial license.

1.2 Ownership Control & Downstream Investment

Before PN 12 was introduced, the applicant company had to be an Indian company “owned”³ **and** “controlled”⁴ by resident Indian citizens. Under the changes brought about by PN 12, a defense company is not required to be “owned” and “controlled” by Indians, and key managerial positions can be held by non-residents as well. Further, in the FDI Policy, the erstwhile requirement of having a single largest Indian equity owner holding 51% shares has been dispensed. Thus, 2 or more Indians can cumulatively hold 51% shares. In such a situation no single Indian will be considered to have majority ownership or exercise control over the investee company in its individual capacity, and all of them have to act in a concerted manner to exercise control.

FDI into Indian companies may either be *direct or indirect*; and total foreign investment is cumulative of direct and indirect investment.⁵ Indirect or downstream investment is by one Indian company that has received FDI in another Indian company by subscription or acquisition of shares.⁶ However, downstream investment by an Indian company will **not** be considered for calculating total foreign investment in two situations. *First*, if the Indian downstream investment entity is “owned” and “controlled” by resident Indian citizens and/or Indian companies, which are ultimately owned and controlled by resident Indian citizens because in such cases, the investee will be considered a domestic company. *Second*, downstream investment is done in 100% subsidiaries of operating-cum-investing/investing companies since in such case it will be identical to the investment in the holding company. Additionally, Section 186 of the Companies Act, 2013 restricts investments up to 2 layers. Therefore, investment beyond 2 layers is not permissible.

2. Hike to 49%: Desired result or not?

The moot question remains has the hike to 49% energized the defense sector? Sadly, the overall perception (and reality) is generally in the negative. Generally, shareholding

¹ Manufacture of defense items such as tanks, warships, arms and ammunitions, defence and space aircrafts, allied parts

² Software development, maintenance services, repair and Overhaul, research & development

³ This means 50% equity is beneficially owned by resident Indians and/or Indian companies owned and controlled by resident Indians

⁴ This means power to appoint majority directors or control management, directly or indirectly, through shareholding, management rights or agreement

⁵ According to Paragraph 4.1.3(ii) of the FDI Policy, indirect foreign investment will be considered for computing total foreign investment

⁶ Paragraph 3.10.2(i) of the FDI Policy

percentage determines shareholders' ownership and control and usually board appointments are proportionate to such percentage. The management structure is contractually negotiated and agreed. Is there a benefit of 49% shareholding then in defense manufacturing companies?

Under the Companies Act, all board decisions are taken by a simple majority of the directors present and voting, except for appointment of the same person as managing director in another company and making investments, giving loans to other corporations, in which case unanimous consent of all the directors is required. There should be valid quorum at Board meetings (i.e. 2 for private and 3 for public companies), and interested directors⁷ are not considered for quorum and voting. In any joint venture, the majority shareholder usually seeks to control the Board which enables them to pass resolutions, despite dissent of the minority shareholders' directors. Unfortunately, with the current limit at 49% a foreign investor cannot attain majority shareholding nor can it acquire indirect control through management or voting rights due to restrictions contained in the FDI Policy. Thus, participation in board decisions and day-to-day functioning of the JV must be contractually negotiated and truly depends on the respective leverage of the parties.

The law mandates that certain matters require shareholders' approval after the assent of the Board. Shareholder resolutions are classified into *ordinary* and *special*.⁸ The former is one which can be passed by simple majority i.e. if the votes cast by shareholders entitled to vote in its favor are more than votes cast against it, while the latter requires 75% majority i.e. the number of votes cast in favor is at least three times the number of votes cast against it. The law as it stands now gives very limited rights to minority shareholders. Ownership at 10% cannot block special resolutions, which is possible only at 26% and above. At 51%, a partner has direct control over the company, can pass ordinary resolutions and block special resolutions. At 75%, a partner can pass special resolutions and block ordinary resolutions. **It is clear from the foregoing that a shareholder at 49% in a defense manufacturing company receives no special protection; rather, at that level the rights are same as of one at 26%. This is, of course, different in case of entities engaged in services or R&D.**

Conclusion

Ever since the hike of the sector was enhanced from 26% to 49%, there has been no major foreign investment and the numbers are rather poor. Media reports that only \$5 million worth of FDI has come in after the changes made in August 2014, which is a very low figure given the market potential of over \$150 billion in the next decade and half. The reason is simple. The foreign original equipment manufacturers want management control, without which OEMs are reluctant to transfer proprietary technology.

The objective of the government while introducing PN 12 has been to simplify FDI procedures; for instance, dropping the requirement to secure prior FIPB approval. The government has definitely moved in the right direction by enhancing FDI to 49% and should provide a boost to the *Make in India* plans. Yet, the challenge remains if such increase brings any

⁷ A director is said to have interest in a contract or arrangement, if the contracting party is either (i) director's relative, (ii) a firm in which director or his relative is a partner, (iii) a company in which the director is on Board or is a member; or (iv) an association of individuals in which he or his relative is a member

⁸ Special resolution matters include amendment of charter documents, shifting of registered office, mergers, acquisitions, buy-back, reduction, change of name, diversification of business, etc.

distinct advantage to the OEMs interested in Indian defense. Will such small steps help in creation of a strong Indian defense industrial base with export potential? As noted, the material question will always be the willingness of a technology owner to transfer proprietary technology sans real, material control.

Mr. Modi's government needs to walk the talk faster if he has to realize the dream of making India self-sufficient with key strengths and strong in-house defense capabilities!

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