FDI Reforms Version 2.0: Real or Notional

Introduction

On June 7, 2016 the Department of Industrial Policy & Promotion (**"DIPP"**) under the Ministry of Commerce issued the consolidated foreign direct investment or FDI policy. On June 20, 2016, twenty-four months into its first term the government of India announced "radical" reforms through a issue of press release. The last set of reforms by the same government was in November 2015, shortly after an electoral debacle in the state elections. While the political pundits and the opposition have continued to play the usual game and attribute a variety of reasons for the timing of the current announcement, but that should not be and is not material. It is important to see whether, after the liberalization of the Indian economy in 1992,[1] the present announcement will muster the same degree of interest, enthusiasm and, most importantly, the type of investment that the government has been hoping for. The changes are positive and a necessary step in the right direction. On June 24, 2016 DIPP has formally notified them by issue of Press Note 5 of 2016 and these changes have come into immediate effect.

This newsletter describes the changes to the FDI regime and briefly discusses the aspirations and the expectations from them with a focus on selective sectors and only an overview of others.

1. The Changes – Version 2.0

In November 2015, the government announced certain key changes in 15 areas which, amongst others, included dispensation or easing of some obsolete conditions in certain sectors, enhancement of FDI up to 49% in the defense sector under the automatic route versus seeking prior approval of the government,[2] 100% FDI in completed construction projects, some plantation sectors[3] cable networks, direct-to-home services and some air transport activities. The broadcast sector saw an enhancement of FDI in news channels from 26 to 49%. Realizing the value of e-commerce, the government permitted single-brand retail firms to sell products through electronic platforms, but subject to government approval. The foregoing does not cover the full details of the 2015 changes, but suffice to say that there were visible steps to bring about reform in order to boost investment. Effectively, that did not happen in many areas and the biggest disappointment was in the defense sector. Industry in general and, foreign investors in particular, were reluctant to license proprietary technology in order to give a boost to "*Make in India*" endeavor of the government mostly because there is no real control at 49%. As a result, investors did not really take those changes too seriously. Hence, the stage was already being set for round two of liberalization.

---

[1] The Indian economy was liberalized in July 1992 and, since then, subsequent changes have been carried out over the next two decades, but the investors and India Inc. wanted a different pace to keep itself aligned with global developments.

[2] Such investment approval is issued by the Foreign Investment Promotion Board or FIPB.

[3] The government opened plantation activities in coffee, rubber, cardamom, palm oil tree and olive oil tree to 100% FDI. Till then, only tea plantations were open to foreign investment.

The latest announcements of 2016 are described below.

1.1 *Civil Aviation*: Currently, the FDI limit is 49% under the automatic route, and overseas entities, barring airlines, can own 100% in domestic airlines. Now:

- 100% FDI is permitted under the automatic route in brownfield airport projects;
- For airlines, while 100% FDI is permitted, but with a caveat. FDI up to 49% is permitted under the automatic route and beyond that, it is necessary to seek the prior FIPB approval. However, foreign airlines would continue to be allowed to invest in capital of Indian companies operating scheduled and non-scheduled air-transport services up to 49% of the paid-up capital only.[4] In effect, this excludes the foreign airlines looking at the Indian skies;
- Non-resident Indians can invest up to 100% without any prior approval in aviation generally.

While the 49% limit will restrict foreign carriers to acquire majority control, yet, the overall increase to 100% could potentially make Indian carriers attractive to foreign capital markets. Further, there may be chances that through collaborations with funds or other investment entities in their home jurisdiction but with an interest in India, foreign airlines may be able to devise creative structures such that they are able to go beyond 49% and partner with an existing airline, all within the permissible framework. The easing of the norms could, hopefully, infuse capital which, in turn, could revive aviation and allow upgrade the infrastructure at many airports. Needless to say, it will be imperative to stay within the recently announced Civil Aviation policy as well.

1.2 *Defense:* As noted, a consistent concern of the foreign investors has been the lack of real control either at 26% or even after the November 2015 increase to 49% under the automatic route and, therefore, their consequential reluctance to invest in India. The government has agreed to look at proposals above 49% and grant approvals on a case-to-case basis, provided, in their opinion, there would be access to modern and *state-of-the-art* technology for India. What constituted state-of-the-art was never defined, but, left to the judgment of the officers who had to consider such proposals and it was incumbent that their considered opinion was that India **needed** such technology thereby bringing a high degree of subjectivity in the rules. With the recent changes, foreign investment beyond 49% has been permitted, again with prior approval of the government. The major shift is that the requirement of *state-of-the-art* has now been removed, and, instead, they will now consider cases resulting in access to *modern* technology. This is a step in the right direction which ought to have the desired effect of encouraging local manufacturing and build domestic capability in a sector that requires critical upgrades through greater collaborations with foreign original equipment manufacturers and their suppliers through technology transfer. Further, the government has clearly stated that their objective will be "providing major impetus to employment and job creation in India."[5]

[4] There is greater foreign participation in aviation. In 2013, Jet Airways had sold 24% stake to Etihad; Vistara run by Tata SIA is a joint venture between Tata Sons (51%) and Singapore Airlines Ltd (49%), while AirAsia India is a joint venture in which AirAsia holds 49% and Tata Sons 51%.

[5] The press release states this unequivocally as a statement of Prime Minister Narendra Modi.

1.3 *Single-Brand Retail*: While the restrictions in defense can be understood easily on account of the paramount concerns of "national security," the failure of the government to open the retail sector has, perhaps, attracted greater controversy on account of the impact on local vested interests. Indian retail is divided into two categories: *multi-brand*, i.e., large supermarkets and department stores; and *single brand,* which is far more linked with well-known brands permitted to sell their own products. The threat to local interests comes predominantly from the multi-brand sector and, therefore, the restrictions remain.

In contrast, however, single-brand retail has been progressively encouraged and liberalised. The current regime allows foreign retailers to set up 100% subsidiaries, though only 49% can come through the automatic route and beyond that prior FIPB approval is required. Additionally, the FDI policy obligates companies opening wholly-owned stores to comply with the local sourcing norms of 30% within five years of their first store opening. Essentially these sourcing norms, which kick in when FDI crossed 51%, stipulate that companies source 30% of the value of goods purchased, *preferably* from micro, small and medium enterprises, village and cottage industries, artisans and craftsmen. The investors viewed these requirements as obstructive and a potential compromise on quality of the products. The debate[6] has seen different highs and lows over the years, culminating in visits by high-level officials of such companies who have tried to prevail upon the government to shift from such norms. It seems that now there is a move in the right direction, though there are ample critics too. Now, the requirements of local sourcing norms for single-brand retail trading have been relaxed for products deemed as having *state-of-the-art* and *cutting edge* technology up to three years and a further relaxation for another five years. Until the present announcement, there was no time limit for exemption from local sourcing norms. While there is no unambiguous definition of *state-of-the-art*, technology that has never been made before in India and cannot be replicated is worthy of being considered as *cutting-edge.* In order to minimize interpretational twists, DIPP intends to set up a committee to define cutting-edge and state-of-the-art so that there is no confusion of the terms. The committee would consist of comprise DIPP secretary, member of *Niti Aayog,* the body that replaced the erstwhile Planning Commission, and representatives of the relevant administrative ministries.

1.4 *Pharma:* The current rules require FIPB approval for brownfield ventures in pharma and, in an effort to prevent takeover by foreign drug manufacturers, the regulators had posited that existing ventures will face a scrutiny on different counts, including a review by the Competition Commission of India to assess the non-compete clause, which is not allowed except in special circumstances. This was largely done to prevent generic drugs and increased cost of medication by foreign companies. The current policy allows 100% FDI under automatic route in greenfield[7] pharma and up to 100%, with prior government approval, in brownfield pharma companies with a right to impose further conditions. Now, this government approval will be required only when the investment is beyond 74% in brownfield pharma. In other words, investment up to 74% will be under the automatic route. The industry and market expectation is that the easing should provide an impetus to M&A activity in pharma which was suffering due to the lack of certainty in the regulations. It is now possible that either global pharma companies or pure financial investors, who are keen to invest or acquire Indian drug

[6] The objective of the Indian government has been to ensure of job generation, which has long been the backbone of the sourcing norms.
[7] This means investment by forming in a new company.

companies, will be able to do so more easily by buying up to 74% equity without any prior clearances from the government. But, drug manufacturers invest a lot in R&D and, therefore, strategic investors will potentially take their own time to analyze the long-term impact of the changes and how that affects in-country and company (at a global level) strategies before making a bee-line to enhance their stakes or acquire new ones in India.

1.5 *Formation of branch, liaison or project office:* A very popular form of presence in India is through an unincorporated entity structure i.e., by means of establishment of a branch, liaison or a project office. For this, a foreign company requires prior approval of the Reserve Bank of India and there is a fairly onerous set of documentary and financial requirements, and applications undergo scrutiny by the relevant administrative ministries as well. Such scrutiny is heightened when the industry is a sensitive one. Now, the government has decided that if the principal business of an applicant is defence, telecom, private security or information and broadcasting, RBI approval or separate security clearance would not be required in cases where FIPB approval is in place or where the necessary permission has been granted by the concerned sector-specific regulator.

1.6 *Some Other Areas:* The current policy of 49% FDI with prior government approval in private security agencies has been modified to permit FDI up to 49% under automatic route and beyond that up to 74%, under government approval route. Then, FDI in animal husbandry (including breeding of dogs), pisciculture, aquaculture and apiculture is allowed 100% under the automatic route under controlled conditions and the requirement of controlled conditions has been revised.[8] Further, 100% FDI for trading of food products manufactured or produced in India, including through e-commerce, will be permitted with prior approval.

Conclusion

The increase of FDI in cases under the automatic route really means that companies have to notify the RBI **after** making the investment versus seeking a prior approval. It is clear that version 2.0 of the current proposals are aimed at boosting and facilitating greater inflow of FDI in India. In an effort to substantiate the point, the official press release of June 20 stated that the said measures undertaken by the government till now have resulted in increased FDI inflows at USD 55 billion in the fiscal year ending March 31, 2016 while the figures at March 31, 2014 stood at USD 36 billion. However, a number of concerns remain as highlighted in the foregoing sections, and more work needs to be done by the regulators and policy makers to ensure that should the floodgates open this time around, the government is equally prepared to deliver in a swift manner and live up to its commitment to the ease doing business in India so that the changes are real and do not remain notional. While the Chinese economy continues to face its own set of growth challenges, perhaps, with the issue of FDI Policy of 2016 and the corresponding Press Note 5 of 2016, it is time for India to move even more center-stage on the world stage.

Author
Priti Suri

[8] See revisions to paragraph 5.2.1.1 of the FDI policy under Press Note 5 of 2016.