INDIA EASES FOREIGN INVESTMENT NORMS IN DEFENCE, PHARMACEUTICALS, AND OTHER KEY SECTORS

Introduction

India's foreign investment regime has been liberalized significantly in the last couple of years. On June 20, 2016, the Indian government announced a host of reforms to further liberalize foreign investment in the defence, pharmaceuticals, retail trading, civil aviation and broadcasting carriage services sectors, as also in private security agencies, and the Department of Industrial Policy and Promotion has just issued Press Note 5 (2016 Series) to make this effective.

This update discusses and critiques the reforms.

Defence sector

Foreign investment in the defence sector above 49% was permitted with the prior approval of the Foreign Investment Promotion Board (the "**FIPB**") on a case-to-case basis, if it was likely to result in access to modern and "state-of-art" technology in the country. <u>The government has decided to modify this and has permitted foreign investment in the defence sector above 49% if it will</u> result in access to modern technology or for other reasons that the government must record. The term "state-of-art" has been deleted.

Further, the manufacture of small arms and ammunitions covered under Arms Act, 1959, has also been opened up for foreign investment on the same limits and conditions applicable to the defence sector.

Since coming to power in 2014, the Modi government has focused on liberalizing foreign investment in the defence sector and to making India a defence equipment manufacturing hub. However, the liberalization measures did not achieve any significant increase in foreign investment in this sector. One of the contributing reasons for this has been the lack of clarity as to what constitutes "state-of-art" technology. <u>Although the government has deleted the term "state-of-art", in our view, the conditions on the basis of which approval can be granted still remain vague. However, investors can make out a case to obtain government approval on grounds that their technology is modern or that they have long-term investment plans to establish manufacturing facilities which will generate employment in India</u>.

Pharmaceutical sector

In the pharmaceutical sector, prior approval of the FIPB will now not be required for brownfield foreign investment up to 74%, i.e., a foreign investor can buy up to 74% of an existing Indian pharmaceutical company without FIPB approval. Earlier, any brownfield foreign investment in the pharmaceutical sector required FIPB approval.

<u>This change will enable existing Indian players in attracting foreign investment more quickly as the FIPB approval requirement has been liberalized</u>.

Retail trading sector

The Indian government has permitted up to 100% foreign investment in retail trading of food products manufactured or produced in India through brick and mortar stores and e-commerce, but with the prior approval of the FIPB.

The move to permit 100% foreign investment in retail trading of food products manufactured or produced in India will definitely benefit India's agricultural sector. Companies like Walmart who are already doing cash and carry wholesale trading can take advantage of this liberalization and start retailing Indian food products to end customers. Additionally, this clears the air for a number of online grocery stores who have foreign private equity fund investors.

In addition, in the single brand retail trading sector, for foreign investment beyond 51%, the requirement to source 30% of the value of goods purchased from India will not be applicable in the first three (3) years of commencement of the business, i.e., from April 1st of the year of opening of the first store, if the products being retailed have "state-of-art" and "cutting edge" technology and where local sourcing is not possible.

Recently, Apple had made an application to the FIPB to relax the sourcing requirements completely given that the products retailed by Apple encompassed "state-of-art" and "cutting edge" technology. However, Apple's application was declined by the FIPB. While the relaxation of sourcing requirements is welcome, again, it is unclear what constitutes "state-of-art" and "cutting edge" technology. Additionally, it appears that applicants will be required to prove that the products cannot be sourced locally. Apple products, which are commonly accepted as having established industry standards in the smart phone and tablet markets, did not pass this test the first time around. Therefore, we hope that the government comes out with a guidance note to clarify the scope of "state-of-art" and "cutting edge" technology.

Civil aviation sector

100% foreign ownership of brownfield (operational) Indian airports is now permitted without the need for FIPB approval, i.e., foreign investors can invest and own an operational Indian airport up to 100%. Earlier, brownfield foreign investment in the airport sector above 74% required FIPB approval.

The existing airport infrastructure in smaller towns in India is in dire need of upgradation, as the Indian government has mainly focused on developing the metropolitan airports. With air traffic in India growing significantly, the semi-urban cities and towns are likely gain prominence, and the opportunity to earn returns on modern airports in these cities will be significant. This move to liberalize brownfield foreign investment in the airports sector will give the much needed fodder to this industry and also aid in building infrastructure.

Foreign investment in the scheduled air transport service sector or domestic scheduled passenger airline sector, and regional air transport service sector was capped at 49% under the automatic route. However, now, foreign investment in these sectors can be up to 100%; however, FIPB approval will be required for foreign investment above 49%. As before, for non-resident Indians, 100% foreign investment is permitted in these sectors under the automatic route.

The scheduled air transport sector has witnessed significant foreign investment activity in the past few years with investments from Etihad Airways, Singapore Airlines and AirAsia. The move to liberalize the scheduled air transport sector will attract foreign investors seeking to benefit from the growth of domestic air traffic in India.

Broadcasting carriage services sector

Up to 100% foreign investment is permitted in broadcasting carriage services such as teleports, direct to home, cable networks, mobile television, headend-in-the sky broadcasting services and cable networks, without having to obtain prior FIPB approval. Earlier, foreign investment above 49% required FIPB approval.

However, it has been clarified that infusion of fresh foreign investment above 49% resulting in a change in the ownership pattern or transfer of stake of the existing investor to a new foreign investor will require FIPB approval, if the company is not seeking a license or permission from the Ministry of Information & Broadcasting (the "**MIB**").

These changes will help strengthen the Indian government's Digital India initiative by increasing investments in broadband infrastructure and communication, and will lead to an expansion of entertainment, education and e-commerce services. However, the second point, i.e., requirement of FIPB approval if no license is sought from the MIB, makes little sense, and will actually have the effect of having to obtain FIPB approval in all cases.

Private security services

In the private security services sector, prior FIPB approval will now not be required for foreign investment up to 49%. However, approval of the FIPB will be required for foreign investment above 49% and up to 74%. Earlier, foreign investment in private security agencies was permitted up to 49% with the prior approval of the FIPB. To enable this change, the Private Security Agencies (Regulation) Act, 2005 will have to be amended.

Establishment of liaison, branch or project offices in certain sectors

As per the recently revised foreign exchange regulations for establishment of liaison, branch or project offices, prior approval of the Reserve Bank of India is required if the principal business of the applicant is defence, telecom, private security or information and broadcasting. Now, prior approval of the Reserve Bank of India or a separate security clearance will not be required if the applicant has already been granted an FIPB approval, or a license or permission from the concerned ministry or regulator.

This change is unclear as establishment of a liaison, branch or project office does not require FIPB approval.

Conclusion

The Indian government is committed to making India an open economy. The foreign investment liberalizations definitely signify a move in this direction. Although some fetters and controls continue, it must be appreciated that the Indian government is open to feedback from the investors and is evolving India's foreign investment regime continuously. The effects of all this will, most likely, be witnessed in the long run.