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NEW YEAR BEGINS WITH FURTHER LIBERALISATION OF THE FDI POLICY

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Background

The Department of Industrial Policy & Promotion (DIPP), on 23 January 2018, by way of Press Note No. 1 (2018 Series) (PN 1), notified certain amendments to the Consolidated Foreign Direct Investment Policy dated 28 August 2017 (FDI Policy).

These changes have been made with the intention of liberalising and simplifying the FDI Policy to promote ease of doing business in India. This newsflash highlights the major changes introduced in the FDI Policy.

Details of the proposed changes

- Single Brand Retail Trading (SBRT)

  - FDI, in excess of 49% of the paid-up capital of a company engaged in SBRT, required the approval of the DIPP. This has now been done away with and 100% FDI is allowed through the automatic route in the SBRT sector.

    Comment

    The government had been contemplating allowing 100% FDI in the SBRT sector under the automatic route for a while. The proposed amendment comes at a time when companies are actively lobbying for easier regulatory approvals in relation to the SBRT sector, and is in line with the gradual steps being taken by the government to liberalise the sector and cut delays in the flow of such investments.

    This amendment will make it easier for foreign brand owners to incorporate wholly owned subsidiaries in India to undertake SBRT, without tying up with any local Indian partner. This will also enable them to exercise greater control over their business in India.

  - Under the FDI Policy, companies that are engaged in SBRT and have foreign investment in excess of 51% (Majority SBRT Entities) are required to source 30% of the value of goods purchased from India (Local Sourcing Norms).

The Local Sourcing Norms have been tweaked and now, companies engaged in SBRT are permitted to set off their 'incremental sourcing' of goods from India, for global operations during the initial 5 years, beginning 1 April of the year of the opening of first store.

After completion of this 5-year period, the SBRT entity shall be required to meet the 30% sourcing norms directly towards its Indian operations, on an annual basis.

Comment

The Local Sourcing Norms that were applicable to entities undertaking SBRT in India required Majority SBRT Entities to source at least 30% of the value of the purchased goods from India. The Local Sourcing Norms had to be met; initially as an average of 5 years' total value of the goods purchased by the company, beginning 1 April of the year during which the first tranche of FDI was received, and thereafter on an annual basis.

The revised Local Sourcing Norms will permit Majority SBRT Entities to off-set additional global sourcing (above current levels) to satisfy the Local Sourcing Norms.

This is a welcome step, especially for the apparel industry as several brands presently source products from India for their global operations. If such brands increase their sourcing for global operations from India, such increased sourcing can be offset against the requirements of the Local Sourcing Norms. However, this offset is available only for a period of 5 years and Majority SBRT Entities will need to comply with the Local Sourcing Norms for their retail operations in India thereafter.

- The additional conditions prescribed under the FDI Policy, in relation to FDI in SBRT viz. products sold to be of a single brand, products sold to be branded during manufacturing, etc., shall remain.

➢ Civil Aviation

- Under the FDI Policy, foreign investors, including foreign airlines, were allowed to invest, under government approval route, in the capital of Indian companies operating scheduled and non-scheduled air transport services, up to the limit of 49% of their paid-up capital. However, the said condition was not applicable to Air India.

- The government has done away with this restriction, and PN 1 has permitted foreign airlines to invest up to 49%, in Air India under approval route. However, such investment in Air India is subject to two conditions:

  - foreign investments in Air India including that of foreign airlines cannot exceed 49% either directly or indirectly; and

  - substantial ownership and effective control of Air India would continue to be vested in Indian national(s).

Comment

The aforesaid changes have been made to facilitate the disinvestment of the government from Air India.

- Construction Development: Townships, Housing, Built-up Infrastructure and Real Estate Broking Services

  Paragraph 6 of PN 1 clarifies that real-estate broking does not amount to real estate business and is, therefore, eligible for 100% FDI under automatic route.

  Comment

  The FDI Policy currently defines Real estate business as "*dealing in land and immovable property with a view to earning profit there from and does not include development of townships, construction of residential/ commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships. Further, earning of rent/ income on lease of the property, not amounting to transfer, will not amount to real estate business.*"

  Given the broad definition of the real estate business, the aforesaid clarification is indeed a welcome move. Prior to the clarification, it could have been argued that real estate broking falls under the ambit of real estate business, although, in essence, real estate broking does not involve any ownership in real estate.

  Additionally, since real estate broking is under the 100% automatic route and does not fall within any of the sectors under the FDI Policy wherein conditions have been prescribed for receiving foreign investment, Limited Liability Partnerships (LLPs) are also permitted to engage in real estate broking, and receive foreign investment under the automatic route.

- Power Exchanges

  In terms of the FDI Policy, FDI up to 49% was permitted under the automatic route in power exchanges registered under the Central Electricity Regulatory Commission (Power Market) Regulations 2010. However, FII/FPI purchases were specifically restricted to the secondary market.

  PN 1 has now deleted this provision, thereby allowing FIIs/FPIs to invest in power exchanges through the primary market.

- Issue of equity shares against non-cash consideration

  As per the FDI Policy, issue of equity shares against non-cash consideration like pre-incorporation expenses, import of machinery, etc. was permitted under government approval route.

  This position has now been partially liberalised and issue of shares against non-cash consideration like pre-incorporation expenses, import of machinery, etc. shall be permitted under the government route *only* for sectors requiring government approval. Accordingly, issue of shares against non-cash consideration would not require prior government approval for sectors under the automatic route.

  However, even for sectors under automatic route, issue of equity shares against such non-cash consideration is permitted under automatic route subject to compliance with certain conditions including approval of the shareholders by way of a special resolution and customary reporting requirements under the FDI Policy.

- Foreign investment into an Indian company, engaged only in the activity of investing in the capital of other Indian company/ies/ LLP and in the Core Investing Companies (CIC)

Under FDI policy, foreign investment in an Indian company that is engaged only in the activity of investing in the capital of other Indian companies/ LLPs, required prior government approval, regardless of the amount or extent of foreign investment.

PN 1 clarifies that foreign investment in investing companies registered as Non-Banking Financial Companies (NBFC) with the RBI, would be under 100% automatic route.

PN 1 further clarifies that FDI in CICs and other investing companies, engaged in the activity of investing in the capital of other Indian companies/LLPs, is permitted under government approval route. CICs will have to, additionally, follow RBI's regulatory framework for CICs.

Comment

PN 1 clarifies that in instances where a company is a CIC, foreign investments in such CICs would require prior approval of the Department of Economic Affairs.

- Competent Authority for examining FDI proposals from countries of concern

Earlier, FDI from 'countries of concern' (i.e., Pakistan and Bangladesh), were processed by the Ministry of Home Affairs (MHA) even if such investments were made in sectors under the automatic route. FDI from countries of concern in activities under the government approval route sectors/activities requiring security clearance were processed by the respective Administrative Ministries/Departments.

This process has been revised and now, the DIPP (not MHA) would process FDI applications in relation to investments in automatic route sectors which require approval only in case the investment is from a country of concern.

Comment

Generally, the process of obtaining security clearance from the MHA is time consuming, leading to delays, in some cases, of more than 6 months. It appears that the government has taken note of this delay and has tasked the DIPP with the role of reviewing such applications involving investments in automatic route sectors by entities from a country of concern.

- Pharmaceuticals

The definition of 'medical devices' has been amended in the FDI Policy.

- Audit firms

PN 1 imposes certain conditions with respect to auditors that can be appointed by the Indian investee companies receiving foreign investments.

Accordingly, in case a foreign investor wishes to specify a particular auditor/audit firm that has international network to be appointed as an auditor for the Indian investee company, then:

- audit of such investee companies should be carried out as joint audit; and
- one of the auditors should not be part of the same network.

Comment

The rationale for imposition of the abovementioned conditions is not clear. This may also increase the cost of doing business in India if a foreign investor wishes to use its global auditor to audit its Indian subsidiary.

Comment

The changes introduced by the DIPP are certainly a welcome change and in line with the steady stream of reforms being introduced to liberalise the foreign investment regime and attract more foreign investment. However, it must be noted that these reforms shall only come into effect when consequent changes are made to the provisions of the Foreign Exchange Management (Transfer and Issue of Securities to Persons Resident Outside India) Regulations, 2017.

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