

NOVEMBER 2015

## RECENT REFORMS IN INDIA'S FOREIGN DIRECT INVESTMENT POLICY

### 1. Introduction

Earlier this month, the government of India eased restrictions on foreign direct investment (“FDI”) in India with a view to promoting the ‘Make in India’ and ‘Startup India’ initiatives<sup>1</sup>.

The reforms are wide ranging and aim to ease doing business, simplifying and rationalizing the process of FDI. The key highlight of the recent reforms is that more FDI proposals in more sectors will now be placed under the automatic route and not require the consent of the government. Of particular note is the liberalization in the Broadcasting, Construction, Defense and Single Brand Retailing sectors.

### 2. Sectors liberalized

We set out below the key differences between the old FDI policy and the new FDI policy in each of sector of the economy (or transaction type) that has been further liberalized.

#### 2.1 Manufacturing

At the outset, it should be noted that the definition of “**Manufacture**” in the FDI policy has been amended to mean:

*“a change in a non-living physical object or article or thing (a) resulting in transformation of the object or article or thing into a new and distinct object or article or thing, having a different name, character and use; or (b) bringing into existence of a new and distinct object or article or thing with a different chemical composition or integral structure.”*

Subject to the provisions of the FDI policy, FDI in the manufacturing sector is permitted and further, a manufacturer is permitted to sell its products manufactured in India through wholesale and/or retail, including through e-commerce without government approval.

Previously, the position was that an Indian manufacturing company having FDI was not allowed to do retail trading in any manner whatsoever through e-commerce.

This is a welcome change from the previous policy and is clearly designed to further encourage investors to ‘Make in India’.

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<sup>1</sup> DIPP Press Note 12 (2015 series) dated November 24, 2105 - [http://dipp.nic.in/English/acts\\_rules/Press\\_Notes/pn12\\_2015.pdf](http://dipp.nic.in/English/acts_rules/Press_Notes/pn12_2015.pdf)

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#### 2.2 Construction

Under the old FDI policy, the minimum area to be developed was 20,000 square meters and a minimum amount of USD 5,000,000 had to be invested within 6 months of the commencement of business. The new FDI policy removes both of these requirements, which will allow foreign equity to access smaller developments.

Previously, foreign investors were permitted to exit projects only upon completion or the development of trunk infrastructure<sup>2</sup> and the repatriation of FDI or the transfer of equity before project completion by a non-resident investor to a non-resident investor required approval of the Foreign Investment Promotion Board (the “FIPB”).

Under the new FDI policy, a foreign investor is permitted to exit and repatriate its foreign investment before the completion of a project without FIPB approval, provided that a lock-in period of three years (the “**Lock In Period**”) has expired, calculated with reference to the date of each tranche of equity invested.

The new FDI policy also treats each phase of a project as a *separate* project for the purposes of FDI. This means that a major construction development can be broken down into smaller phases and an investment relating to a particular stage of a project can be repatriated even though the larger project still continues to be under construction. The impact should be significant for larger developments like townships and large infrastructure construction projects, insulating foreign investors from the risk of delay to overall project completion.

Under the new FDI policy, the sale of an equity stake from a non-resident to another non-resident, without repatriation of the investment, before the expiry of the Lock In Period is permitted without the consent of the FIPB and an exit is permitted at any time if the trunk infrastructure in relation to the project has been completed.

The new FDI policy goes on to clarify that any rental income or other income arising from the project (that does not amount to a transfer) will not amount to *Real Estate Business*. The previous policy barred FDI in the *Real Estate Business*, defined to be the relevant portion of any business, “*dealing in land and immovable property with a view to earning profit or earning income therefrom*” and the revised position is a welcome step to encouraging foreign real estate investors to invest in the construction sector.

The new FDI policy further clarifies that the transfer of ownership of an investment vehicle from residents to a non-resident is also permitted following the expiry of the Lock In Period. While the previous FDI policy did not define *transfer*, the new FDI policy clarifies that it means: (i) the sale,

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<sup>2</sup> Meaning roads, water supply, street lighting, drainage and sewerage.

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exchange or relinquishment of the asset; (ii) the extinguishment of rights therein; (iii) its compulsory acquisition under law; (iv) any transaction allowing the possession of immoveable property of the nature referred to in section 53 A of the Transfer of Property Act 1882;<sup>3</sup> and (v) any transaction involving the acquisition of shares in a company or any agreement or arrangement which has the effect of transferring, or the enabling of enjoyment of, any immoveable property.

Hence under the new FDI policy, it is clear that the sale of shares in an offshore holding company, holding property through its Indian subsidiary, following the expiry of the Lock In Period will now be permitted.

#### 2.3 **Defense**

Under the old FDI policy, foreign investment of up to 49 per cent in an Indian joint venture was permitted under the government approval route. Portfolio investment and investment by Foreign Venture Capital Investors (“FVCIs”) was restricted to 24 per cent. Foreign investment above 49 per cent was permissible, but subject to approval by the Cabinet Committee on Security.

The new FDI policy substantially improves the situation. Foreign investment up to 49 per cent will now be permitted under the automatic route and portfolio investment and investment by FVCIs is also permitted up to 49 per cent under the automatic route. Foreign investment above 49 per cent will be considered by the FIPB.

Further, it should be noted that in the event of infusion of fresh foreign investment, within the permitted cap, resulting in a change in ownership or the transfer of a stake by an existing investor to a new foreign investor, government approval will be required.

#### 2.4 **Broadcasting**

Previously, up to 26 per cent FDI was permitted under the approval route in the case of FM radio broadcasting, the up-linking of news and current affairs television channels. Also, FDI up to 100 per cent was permissible under the Government approval route for the up-linking of non-news and current affairs TV channels and the down-linking of TV channels.

Now, up to 100 per cent FDI is permissible in the following broadcasting carriage services outlined in FDI Policy, namely teleports, Direct-To-Home, Cable Networks, Mobile TV and

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<sup>3</sup> The provision basically refers to such contracts where the transferee has either taken steps or continues to be in possession of immoveable property as a part performance of the contract.

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Headend-In-The-Sky Broadcasting Services. FDI of up to 49 per cent is permissible under the automatic route while acquiring anything more than 49 per cent would require Government approval.

In relation to broadcasting content services, FDI up to 49 per cent is permissible under the government approval route in case of FM radio and the up-linking of news and current affairs TV channels. Further, FDI of up to 100 per cent is permissible under the automatic route in the case of up-linking of non-news and current affairs TV channels as well as the down-linking of such TV channels.

Where the sectoral cap is 49 per cent, new FDI policy further clarifies that the company would need to be owned and controlled by resident Indian citizens and Indian companies, which are owned and controlled by resident Indian citizens. Hence the largest Indian investor should hold 51% of the total equity, excluding the equity held by Public Sector Banks and Public Financial Institutions.

#### 2.5 **Banking**

The new FDI policy now permits full *fungibility* of foreign investment in the private banking sector. Accordingly, Foreign Institutional Investors, Foreign Portfolio Investors and Qualified Foreign Investors can now invest up to the sector limit of 74 per cent provided that there is no change of control and management of the investee company.

#### 2.6 **Plantations**

Earlier, the FDI policy prevented foreign investment in the plantation sector other than in tea plantations. Under the new FDI Policy, in addition to tea the government has decided to open up coffee, rubber, cardamom, palm oil and olive oil plantations to foreign investment of up to 100 per cent under the automatic route. However, it has been clarified that the prior approval of the state government concerned is required in case of any land use change.

#### 2.7 **Single brand retail**

Under the earlier FDI policy, companies having FDI beyond 51 per cent had to comply with a local sourcing requirement of 30 per cent of the value of goods purchased, preferably from micro, small and medium enterprises (“**MSMEs**”) or similar entities.

This requirement to source from MSMEs has been a particularly controversial requirement for foreign investors selling niche products and has to be fulfilled for a period of 5 years, beginning on 1<sup>st</sup> April of the year during which the first tranche of FDI is received.

The new FDI policy now clarifies that the 30 per cent local sourcing rule applies from the date of first opening the store (as opposed to the date of receipt of FDI) and that in sectors involving

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*'state-of-the-art'* and *'cutting-edge technology'*, this sourcing norm may be relaxed, subject to government approval. This is a welcome change and should be beneficial for all foreign investors selling niche products whose component parts cannot be sourced from the local market.

More importantly, the previous prohibition on retail trading through e-commerce has been lifted. This is a welcome change since retailers were previously in the curious position of being able to sell through 'bricks and mortar', but unable to sell through 'clicks and mortar'.

Also, under the new FDI policy, certain conditions of the FDI policy requiring products to be sold under the same brand internationally and the investment by the non-resident entity being the brand owner (or through legally binding agreement with the brand owner) have been lifted.

### 2.8 **Duty-free**

Under the new FDI policy, 100 per cent investment is now permissible under the automatic route, setting up duty-free shops located and operated in customs bonded areas at airports in India. Previously, the FDI policy was silent on this sector.

### 2.9 **Wholesale trading**

Earlier, it was not permissible for a single entity to undertake activities in both wholesale trading and single brand retailing. Now, a single entity may undertake both wholesale trading and single brand retailing provided that they carry out such activities separately.

### 2.10 **Civil aviation**

Earlier, foreign investment of up to 49 per cent was permissible in Scheduled Air Transport Services<sup>4</sup> and domestic scheduled passenger airline services. Now, Scheduled Regional Air Transport Services<sup>5</sup> may receive foreign investment of up to 49 per cent under the automatic route.

In relation to chartered services, the position used to be that foreign equity in non-scheduled air transport services and ground-handling services were capped at 74 per cent through the automatic route. The new FDI policy raises the bar, increasing foreign equity investment up to 100 per cent under the automatic route.

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<sup>4</sup> Pursuant to the Aircraft Rules, 1937 Section (3)(49) "**Scheduled Air Transport Service**" means air transport services based on a published time-table so regular that they constitute a recognizable systematic series.

<sup>5</sup> Pursuant to a notification from the Director General of Civil Aviation dated August 23, 2007, "**Scheduled Regional Air Transport Services**" means service which operate primarily in a designated region and which on grounds of operational and commercial exigencies may be allowed to operate from its designated region to airports in other regions, except the metro airports of other regions.

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#### 2.11 Credit information companies

The new FDI policy increases foreign investment into this sector from 74 per cent to 100 per cent under the automatic route.

#### 2.12 Agriculture and animal husbandry

Stringent FDI restrictions regarding genetically modified materials previously applied to this sector and they are relaxed under the new FDI policy.

#### 2.13 Mining and separation of minerals

Again, previously, stringent FDI restrictions applied to this sector, though the new FDI policy plans to liberalize the sector further.

#### 2.14 FDI by entities controlled by NRIs

Earlier, investments made by non-resident Indians (“**NRIs**”) under Schedule 4 of the Foreign Exchange Management Act (Transfer or Issue of Security by Persons Resident Outside India) Regulations (“**Schedule 4**”) was not deemed to be a foreign investment and did not have parity with investment made by residents.

Furthermore, special dispensation for NRIs was not extended to companies, trusts and partnership firms, which were incorporated outside India and were owned and controlled by NRIs.

The new FDI policy addresses partly these points. NRIs now have a special dispensation for investment in construction development and the civil aviation sectors. Further, investment made by NRIs under Schedule 4 is deemed to be a domestic investment at par with investment made by residents.

This special dispensation for NRIs has also been extended to companies, trusts and partnership firms, which are incorporated outside India and owned and controlled by NRIs. Henceforth, such entities owned and controlled by NRIs will be treated at par with NRIs for investment in India.

#### 2.15 Limited liability partnerships

Under the earlier FDI policy, government approval was required for investments in LLPs. Further, the terms ‘*ownership*’ and ‘*control*’ with reference to LLPs had not been defined and downstream investments were not permitted by LLPs.

Under the new FDI policy, 100 per cent foreign investment is now permitted under the automatic route in LLPs operating in sectors or activities where 100 per cent FDI is allowed under the automatic route and there are no FDI-linked performance conditions.

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The term '*ownership*' has also been defined and an LLP is considered to be owned by resident Indian citizens if more than 50 per cent of the investment in it is contributed by resident Indian citizens or entities and such resident Indian entities have a majority of the profit share.

'*Control*' has been now defined to include the right to appoint a majority of the directors or to control the management or policy through their shareholding or management rights or otherwise through shareholders' agreement or other voting agreements. Further in case of LLPs '*control*' would mean the right to appoint a majority of the designated partners, where such designated partners have control over all the policies of the LLP.

LLPs receiving foreign investment will also be permitted to make downstream investment in another company or LLP in sectors in which 100 per cent FDI is permitted under the automatic route and there are no FDI-linked performance conditions. However, the LLP must notify the Secretariat for Industrial Assistance, the Department for Industrial Policy & Promotion and the FIPB of its downstream investment in the prescribed format within thirty (30) days of such investment.

It should be noted that foreign direct investment in legal services is still prohibited.

#### 2.16 **FDI by way of share swaps**

Under the previous FDI policy, government approval was required for investment into a sector by way of swap of shares even in sectors where FDI was permitted under the automatic route. Now, government approval will not be required for investment in sectors permitting foreign investment under the automatic route by way of swap of shares.

#### 2.17 **Threshold limit for FIPB approval**

It should be noted that the threshold limit for FDI approval has been raised. Previously, it was INR 3,000 Crore (INR 30 billion) (approximately USD 450 million). Now, it has been increased to INR 5,000 Crore (INR 50 billion) (approximately USD 755 million).

#### 2.18 **Receipt of FDI in companies without operation**

Indian companies having no operations and which do not have any downstream investment are now permitted to have infusion of foreign investment under the automatic route. However, such companies which intend to do business reserved under the government approval route will have to take the approval of the government prior to such infusion.

Further, as and when such a company commences business or makes downstream investments, it will have to comply with the relevant sectoral conditions and caps.

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#### 2.19 Satellites

The new FDI Policy has relaxed FDI in the above-mentioned sector from 74 per cent to 100 percent under the government approval route.

#### 3 INDUSLAW COMMENT

According to the Department of Industrial Policy & Promotion, India has now thrown open 92.5 per cent of FDI through the automatic route, which is a welcome development. The recent reforms are a necessary change to the regulatory environment in India and another step closer to the goal of full convertibility. However, it will require some time to see whether these changes trigger a spurt in FDI.

It should be noted that the reforms stop short of lifting curbs on multi-brand retailers, such as retail giant Wal-Mart, which to date has focused on its wholesale business in India. That segment was opened to foreign investment in 2012, but the limit remains at 51 percent.

With the Delhi High Court ordering an Enforcement Directorate investigation into 21 e-commerce firms earlier this month for alleged FDI violations, there is a pressing need to rationalize the position in multi-brand retail through e-commerce for further progress to be made.

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