

Regulatory Hotline

January 17, 2018

FDI REFORMS IN INDIA: GOVERNMENT COMMITTED TOWARDS EASE OF DOING BUSINESS

Ahead of the Union Budget for next fiscal year, the Union Cabinet ("Cabinet") chaired by the Prime Minister Shri Narendra Modi met on January 10, 2018 to approve several amendments in the foreign direct investment policy of India ("FDI Policy"), which are expected to have a wide-ranging impact.

The key reforms include:

1. FDI allowed in Single Brand Retail Trading ("SBRT") up to 100% under the automatic route.
2. FDI by foreign airlines allowed in M/s Air India Limited ("Air India") under approval route, provided substantial ownership and effective control continue to be vested in Indian national.
3. FIs/FPIs to acquire shares in 'Power Exchanges' through primary market.
4. Real-estate broking service has been clarified not to constitute a real-estate business and hence, FDI in such services is permitted up to 100% under automatic route.
5. FDI into Investing Companies and Core Investment Companies to be allowed up to 100% under automatic route provided such activities are regulated by any financial sector regulator.
6. Issue of shares against non-cash considerations shall be permitted under automatic route in case of activities falling under automatic route.
7. Audit of the Indian investee company with foreign investment, by an international audit firm of its choice, must be carried out jointly with another audit firm which does not belong to the same network as the international audit firm.
8. The definition of 'Medical Devices' under the FDI Policy is not tied to the definition of 'Medical Devices' under the Drugs and Cosmetics Act, 1940 and the rules made thereunder.
9. Department of Industrial Policy & Promotion ("DIPP") to be the new competent authority for examining FDI proposals under automatic route from countries of concern i.e. Pakistan and Bangladesh.

These reforms are in continuation of the Government's endeavor to liberalise the existing foreign direct investment ("FDI") regime in India. Besides, it is expected to boost the FDI inflows and contribute to the growth of investment, income and employment in the country.

The changes announced are set out below, along with our analysis. The description below is based on the press release¹ issued by the Government of India. The fine print of the actual amendments (to be made to the FDI Policy and the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017 ("TISPRO"), which governs FDI in India) are still awaited.

FDI IN SBRT UNDER AUTOMATIC ROUTE

FDI limits for investment in SBRT under automatic route has been increased up to 100%, from the present 49%, subject to fulfilment of prescribed conditions. One of such conditions is that in respect of proposals involving foreign investments beyond 51%, sourcing of 30% of the value of goods purchased is to be from India, preferably from Micro, Small & Medium Enterprises (MSMEs), village and cottage industries, artisans and craftsmen, in all sectors.

However, the proposed change to the FDI Policy would allow an SBRT entity to set off the mandatory sourcing requirement against its incremental sourcing of goods from India for global operations during initial 5 years (starting April 1 of that year) of opening the first store in India. The incremental sourcing for the purpose of set off shall be equal to the annual increase in the value of goods sourced from India for global operations (in INR terms), either directly or through their group companies.

In other words, if the value of incremental sourcing is equivalent to the value of mandatory sourcing, then effectively there is zero local sourcing requirement for the SBRT entity during the initial 5 years. Post completion of the 5 years' period the SBRT entity shall be required to meet the mandatory 30% local sourcing norms directly towards its India operations on an annual basis.

Analysis: Relaxing the FDI norms for SBRT by allowing 100% FDI under automatic route is a welcome change and it will not only attract additional foreign capital into the country, but will also provide an impetus to the retail industry growth. FDI in SBRT is now expected to gain momentum due to the ease in the process of doing business and not being subject to regulatory scrutiny and approval process. Besides, the option to avail set off against the incremental sourcing is a positive step towards attracting big retail groups to enter into India. However, the revised norms may not appear as attractive for companies engaged in hi-tech segments, as they would be hard pressed to be meet the local sourcing requirements as well as avail of the other option of incremental sourcing of goods by their group

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companies. Unless these companies obtain an exemption from the Government from the local sourcing requirement based on the “state of the art” and “cutting-edge” technology involved in the manufacture of their products, they would find it very difficult to set-up shop in India under these norms.

Further, the aforementioned exemptions from local sourcing norms in case of “state of the art” and “cutting-edge” technology are granted on a case to case basis subject to recommendations to this effect by a committee under the chairmanship of the Secretary, Department of Industrial Policy & Promotion (“DIPP”). Even where they receive such an exemption, as per the current norms, this exemption would only be valid for 3 years post which they would still have to meet the local sourcing requirement. In view of the same, it is unlikely that these proposals will be viewed with increased enthusiasm by such foreign investors.

FOREIGN AIRLINES CAN INVEST UP TO 49% IN AIR INDIA

Currently foreign airlines are allowed to invest in the capital instruments of Indian companies, operating scheduled and non-scheduled air transport services, up to the limit of 49% of their paid-up capital, except in Air India, a Government owned scheduled air transport service. However, in the wake of ongoing divestment process, the Government has decided to relax the norms by allowing foreign airlines to invest up to 49% under approval route, subject to the condition that total FDI in Air India shall not exceed 49% either directly or indirectly and its substantial ownership and effective control shall continue to be vested in Indian national.

Analysis: Allowing FDI up to 49% in Air India subject to abovementioned conditions shall bring the national airline at par with other carriers in which foreign investment was already permitted. In the time when the Government is working on the modalities for strategic divestment of Air India, the proposed change is expected to ease the process of divestment and attract more bidders for the airline. Further, it will not only allow other domestic carriers, jointly with foreign partners, to participate in the bidding process but, will help Air India to strengthen its financial and technical capabilities.

FIIS/FPIs INVESTMENTS IN ‘POWER EXCHANGES’

Foreign investment in power exchanges by foreign institutional investors (FIIs) / foreign portfolio investors (FPIs) is currently allowed only through the secondary market. However, the Government has proposed to relax the FDI norms to allow FIIs/FPIs to be able to invest through primary market as well.

Analysis: The Government’s decision to allow FPI/FIIs to invest in power exchanges through the primary market may have been a bit late for Indian Energy Exchange (which recently concluded its IPO), however it is a positive step towards growth of power exchanges in India. Besides, it has also opened new avenues for the power exchanges to raise capital from institutional investors by way of private placement or preferential allotment.

REAL ESTATE BROKING IS NOT REAL ESTATE BUSINESS

Government’s clarification that real-estate broking services do not constitute real estate business and hence, FDI is permitted in such services up to 100% under automatic route was long overdue. The real estate industry, for a very long time had differing views and interpretations about the status of real-estate broking service. This clarification and subsequent change in FDI Policy shall provide the much needed clarity to the players in the real estate industry.

Analysis: The proposed change is expected to boost the segment by attracting large international brokerage companies to invest in India and set up their subsidiaries here. It will also be a source of encouragement for start-ups in the real estate industry that offer innovative broking products.

FDI IN INVESTING COMPANY

As per the extant FDI Policy, foreign investment into an Indian company, engaged only in the activity of investing in the capital of other Indian company/LLP (i.e. Investing Company) and/or in the core investing company (“CIC”) is permitted up to 100% with prior government approval. However, in light of various representations received by the Government in this regard, it has been proposed to liberalize the policy for FDI into Investing Companies and CICs up to 100% under automatic route, provided they are regulated by any financial sector regulator in India. In cases where only part of the activity is regulated or where there is doubt regarding the regulatory oversight, foreign investment up to 100% will be allowed under the approval route, subject to conditions including minimum capitalization requirement, as may be decided by the Government.

Analysis: The Government’s attempt to align the policy regarding Investing Company and the Core Investing Companies with the provisions on other Financial Services, is a positive step towards easing the process of doing business in India. However, practically while CIC may be regarded as regulated by the Reserve Bank of India but, it would difficult for Investing Companies to obtain registration of any financial regulator for seeking foreign investments under the automatic route, as Investing Companies are currently not required to be registered.

ISSUE OF SHARES FOR NON-CASH CONSIDERATION UNDER AUTOMATIC ROUTE

As per the current FDI policy, issue of equity shares against non-cash considerations like pre-incorporation expenses, import of machinery and others is permitted under government approval route. However, under the proposed law the Government has decided to allow issue of equity shares against non-cash considerations such as pre-incorporation expense, import of machinery etc. under the automatic route in case of sectors under the automatic route.

Analysis: It is yet another welcome step which would significantly reduce the transaction timeline by eliminating two to three months, that is the time consumed in obtaining the Government approval.

JOINT AUDITS BY INDIAN INVESTEE COMPANIES RECEIVING FDI

A new provision has been proposed to be introduced in the FDI Policy pertaining to joint audits of the investee company receiving foreign investments. It has been decided by the Government that wherever the foreign investor wishes to specify a particular auditor/audit firm having international network for the Indian investee company, then audit of such investee companies should be carried out as joint audit wherein one of the auditors should not be part of the same network. In other words, joint audits are now mandatory for Indian companies that receive foreign

investments if an international investor insists on audit by a global firm, or its Indian affiliate.

Analysis: Prior to this change, the FDI Policy did not have any provisions in respect of specification of auditors that can be appointed by the Indian investee companies receiving foreign investments, which had resulted in a practice where the foreign investor and investee company would contractually agree to audit by Big Four firms or Indian firm that are part of their network. However, with the new law in place it is expected that there may be a decline in such practices and the local audit firms would get a fair opportunity to grow its business.

REVISED DEFINITION OF 'MEDICAL DEVICES'

The definition of 'Medical Device' under the extant FDI Policy is subject to amendment to the Drugs and Cosmetic Act, 1940 ("**D & C Act**"). It has been decided that the said definition would no longer be subject to the amendment to D & C Act.

Analysis: This decision has been taken on a very timely basis in light of the extremely restrictive definition of "Medical Devices" in Medical Devices Rules, 2017 ("**New Medical Devices Rules**") issued under the D & C Act that took effect of January 1, 2018. The New Medical Devices Rules define "Medical Devices" to presently cover only 15 categories of medical devices that are regulated as drugs under D & C Act. Had the decision not been taken, it would have led to conflicting interpretation of definition of "Medical Devices". The decision restores the status quo whereby a wide range of items may be categorized as medical devices and a company engaged in its manufacture may attract FDI up to 100% under automatic route. The items include any instrument, apparatus, appliance, implant, material or other articles, whether used alone or in combination, plus any software tool, intended by its manufacturer to be used specially for human beings or animals for diagnosis, prevention, monitoring, treatment or alleviation of any disease or disorder.

FDI PROPOSALS FROM 'COUNTRIES OF CONCERN'

Depending upon the nature of activity and its permissible route of investment, FDI from 'countries of concern' (i.e. Pakistan and Bangladesh) require security clearance from the relevant Administrative Ministries/Departments (in case investments permitted under the approval route) and the Ministry of Home Affairs ("**MHA**") (in case of investments permitted under the automatic route). However, to reduce the burden on MHA and to ease the process of approval, the Cabinet has approved the proposal to change the competent authority from MHA to DIPP for examining the FDI proposals from 'countries of concerns' under the automatic route. Whereas the process for approval of FDI from 'countries of concern' in activities under approval route remains the same.

CONCLUSION

FDI, being a major driver of economic growth and a source for non-debt, long-term finance for the economic development of the country, has been one of top priorities of the current Government. In the past 2 years, we have witnessed many reforms and new initiatives announced by Government across various sectors. One of the common features in most of the reforms has been the focus of the Government towards ease of doing business in India, which has led to India's improved position in the World Bank's report on Ease of Doing Business and earned India an enhanced sovereign rating by Moody's. Most of the proposals discussed above are along similar lines, it either eliminates an existing defect in the system or puts in place a newer innovative mechanism to make the process quicker than before. While India is already seen as one of the most attractive country for FDI, the above-said relaxations would further enhance the inflow of FDI into the country.

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¹ Available at <http://pib.nic.in/PressReleseDetail.aspx?PRID=1516115>

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