TRILEGAL

ANALYSIS

Foreign Direct Investment norms in the Indian defence sector liberalised further

24 September 2020

This analysis covers:

1 Introduction

In May 2020, the Indian Government as part of an economic stimulus package to respond to the Covid-19 pandemic, announced a proposal to liberalize the foreign direct investment (FDI) framework in India for the defence sector. The Indian Government outlined its intention to permit foreign investors to hold up to 74% of the equity share capital of Indian companies engaged in activities falling within the defence sector under the automatic route (i.e. without prior Government approval), potentially paving the way for foreign companies to hold a majority controlling stake in such Indian companies.

Following this announcement, the Indian Government has issued Press Note 4 of 2020 on 17 September 2020 (Press Note) to amend India's Consolidated FDI Policy (FDI Policy). The Press Note will take effect upon an amendment being made to India's exchange control framework by way of a notification to be issued under the Foreign Exchange Management Act, 1999.

> The Government has issued Press Note 4 of 2020 to increase the FDI limit in the Indian defence sector to 74% from 49% under the automatic route. The liberalized FDI limit is intended to permit foreign investment into companies seeking new industrial license only and is subject to the prescribed FDI linked conditions under this press note.

In this update, we have outlined the key changes introduced through the Press Note to the existing FDI framework in the defence sector and its implications on global defence majors currently doing business in India or those planning to set up a defence manufacturing presence in India.

Existing FDI framework and changes under the Press Note

Existing FDI Framework	Proposed Changes under the Press Note
100% FDI in defence industry subject to industrial license (Industrial License) under the Industries (Development & Regulation) Act, 1951 and manufacturing of small arms and ammunition under the Arms Act, 1959 where:	
(a) 49% FDI is permitted under the Automatic Route. (b) any FDI above 49% would require prior Government approval where it is likely to result in access to 'modern technology' or other reasons to be recorded.	(a) 74% FDI is permitted under the Automatic Route. (b) any FDI above 74% would require prior Government approval where it is likely to result in access to 'modern technology' or other reasons to be recorded.
Key conditions:	*Key conditions:*
(a) Infusion of fresh foreign investment within the permitted Automatic Route level (i.e. up to 49%) in a company not seeking an Industrial License will require prior Government approval in case of a change in	(a) Infusion of fresh foreign investment up to 49% in a company not seeking an Industrial License or which already has Government approval for FDI in defence, will require mandatory submission of a declaration to the Ministry of Defence (MoD) in case of change in equity/shareholding pattern or transfer of stake by

Existing FDI Framework	Proposed Changes under the Press Note
the ownership pattern or transfer of stake by existing investor to new foreign investor.	existing investor to new foreign investor for FDI up to 49%, within 30 days of such change. Proposals for raising FDI beyond 49% in such companies will require prior Government approval.
(b) Foreign investment is subject to security clearance and guidelines of the MoD.	(b) Same as existing framework.
(c) The investee company must be self-sufficient in areas of product design and development. The investee/joint venture company and its manufacturing facility, should also have maintenance and life cycle support facility of the product(s) being manufactured in India.	(c) Same as existing framework.
	(d) FDI up to 74% under Automatic Route will be permitted for companies seeking new Industrial License.
	(e) Foreign investment is subject to scrutiny on grounds of national security and the Government reserves the right to review any foreign investment in the defence sector that affects or may affect national security.

2 Preliminary analysis of the Press Note

The proposed liberalization of the FDI Policy for defence manufacturing is a welcome move and could attract large scale investments by foreign defence majors in the sector, thereby adding significant momentum to the Government's Make in India programme.

Some of the key aspects of the FDI changes in the Press Note are summarised below:

2.1 Increased governance and control rights for Foreign OEMs (as shareholders)

The increase in foreign ownership limits to 74% of the share capital of the investee company in India will allow foreign defence majors to exercise substantial ownership and control over the investee company (through majority voting rights as shareholders and a seat on the board of such investee companies). Under the existing FDI framework which capped FDI under the Automatic Route to 49%, foreign shareholders and OEMs were reluctant to transfer critical proprietary technologies to the investee company since they were not able to exercise control over the board and operations of the investee company. This concern has now been addressed to a great extent in respect of new investments which would allow the foreign shareholder to own upto 74% of the share capital of the investee company and to control the operations and actions of such company, thereby allowing for greater protection against any further transfer or alienation of proprietary technology licensed to such investee company.

2.2 FDI in Indian defence manufacturing companies not seeking an Industrial License can be made up to 49% with submission of a declaration post investment/share transfers

Under the existing FDI framework, prior Government approval is required for infusion of fresh foreign investment up to 49% in a company not seeking an Industrial License, in case of a change in the ownership pattern or transfer of stake by existing investor to new foreign investor.

However, this condition under the Press Note has been relaxed from a prior Government approval to a post investment declaration to the MOD. Under the Press Note, infusion of fresh foreign investment up to 49% in a company not seeking an Industrial License or which already has Government approval for FDI in defence, now requires a mandatory submission of a declaration with the MoD in case of a change in equity/shareholding pattern or transfer of stake by existing investor to a new foreign investor and not prior Government approval (as is required under the existing FDI framework). This declaration is required to be submitted to the MoD in respect of such investments as a condition subsequent and within 30 days of such investment or change in shareholding or share transfer taking place. However, the Press Note further states that proposals for raising FDI beyond 49% from such companies will continue to require prior Government approval.

The above language in the Press Note referring to 'a *company not seeking an Industrial License'* carries forward the ambiguity from the existing FDI framework as to whether the FDI limits in the defence sector applies to companies whose activities do not require an Industrial License or which are not engaged in manufacturing of small arms and ammunition under the Arms Act. Historically, it has been understood that FDI restrictions apply only in case of existing defence ventures (or companies holding an Industrial License) or those that were engaged in the manufacturing of small arms or ammunition. It seems unlikely that the regulator intended to cover companies whose activities do not require an Industrial License or which are not engaged in manufacturing of small arms and ammunition (under the Arms Act) under the Press Note, even though it has continued to retain the expression '*company not seeking an Industrial License*'. Therefore, in order to avoid any further ambiguity, it would be helpful if the Government clarified this position.

2.3 Press Note applies prospectively and to new FDI proposals

The Press Note expressly provides that FDI up to 74% under Automatic Route is permitted for companies seeking new Industrial License, thereby permitting foreign OEMs and defence majors to acquire up to 74% of the equity share capital of eligible companies in new investment proposals only.

Any fresh infusion of FDI or change in foreign shareholding in existing defence manufacturing companies beyond 49% (and having a valid Industrial License) will still need prior Government approval.

2.4 National Security as an additional ground for approval and rejection of proposals

Under the existing FDI framework, investments in the defence sector are subject to security clearance and guidelines of the MoD.

However, under the Press Note, foreign investments in the defence sector have additionally been made subject to scrutiny on grounds of national security and the Government has reserved the right to review any foreign investment in the defence sector that affects or may affect national security. While the Press Note does not clarify the considerations involved in evaluating FDI from the perspective of national security, the lack of any further clarity in this regard will need to be factored into investment timelines and transaction certainty.