FURTHER LIBERALIZATION OF THE FDI REGIME

1. INTRODUCTION

The Union Cabinet, on January 10, 2018, approved certain key amendments to the Consolidated FDI Policy Circular of 2017 (the "**FDI Policy**").[1] The amendments aim to further liberalize and simplify the FDI Policy to create a more foreign investor-friendly atmosphere and, in turn, attract more foreign direct investment ("**FDI**") in the country.

Over the past few months, the Government has been making concerted efforts in this direction to increase the *ease of doing business* in the country. This amendment marks another step in a series of steps already taken by the government in this regard, including the recent amendments to the regime governing the transfer and issue of securities held by non-residents[2] and the notification of the new rules consolidating the filing and reporting requirements under the Foreign Exchange Management Act, 1999.[3]

2. KEY CHANGES

The key amendments to the FDI Policy are summarized below.

2.1 Single brand product retail trading

Pursuant to the FDI Policy, foreign investment in entities undertaking single brand product retail trading ("**SBRT**") was allowed up to 100%, with up to 49% being allowed under the automatic route and prior Government approval being required beyond 49%.

The amended FDI Policy now permits up to 100% FDI in SBRT through the *automatic route*. The requirement for obtaining government approval for foreign investment beyond 49% has been done away with. Further, the local sourcing requirement with respect to SBRT has been

[1] http://pib.nic.in/PressReleseDetail.aspx?PRID=1516115

[2] Please refer to Infolex Newsalert on 'Foreign Investment Regulations Amended: Attempt to Ease Foreign Investors' Troubles'

[3] Please refer to Infolex Newsalert on 'RBI Revises Reporting Directions to Align with the Foreign Exchange Management (Transfer or Issue of any Foreign Security) Regulations, 2017'

eased. As a result of the amendment, an entity undertaking SBRT does not need to meet the 30% local sourcing requirement *through its Indian units* for the first five years, *if* the requirement is met through sourcing from India for its global operations, either directly or through its group companies.

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

2.2 Civil aviation

Under the FDI Policy, foreign airlines were allowed to invest under the government approval route in Indian companies (except in relation to Air India Limited ("**Air India**")), operating scheduled and non-scheduled air transport services, up to a limit of 49%. The prohibition on foreign airlines to invest in Air India has now been removed under the amended FDI Policy, and consequently, foreign airlines can now invest up to 49% under the government approval route in Air India. This is subject to the condition that foreign investment in Air India shall not exceed 49%, directly or indirectly, and substantial ownership and effective control shall continue to be vested in Indian nationals.

2.3 Real estate

Under the FDI Policy, real estate business is a prohibited sector and hence, FDI in the real estate sector is not allowed. The amended FDI policy has clarified that a real estate broking service does not amount to a real estate business and therefore, is eligible for 100% FDI under the automatic route.

2.4 Power exchanges

The FDI Policy allows 49% FDI under the automatic route in power exchanges registered under the Central Electricity Regulatory Commission (Power Market) Regulations, 2010. However, foreign institutional investors ("**FIIs**") and foreign portfolio investors ("**FPIs**") could invest only by way of secondary market transactions or subsequent purchases. The amended FDI Policy now allows FIIs and FPIs to also invest through primary markets or subscriptions, subject to sectoral limits.

2.5 Conversion of external commercial borrowings, lump sum fee and royalty into equity

Pursuant to the FDI Policy, the issue of equity shares against non-cash consideration was permitted only under the government approval route. Now, under the amended FDI Policy, the issue of equity shares against non-cash consideration, such as pre-incorporation expenses and the import of machinery shall be permitted under the automatic route in case of sectors falling under the automatic route.

2.6 FDI in an Indian company engaged only in the activity of investing in the capital of other Indian companies (regardless of its ownership or control)

The FDI policy allowed FDI up to 100%, with prior government approval, in companies engaged only in the activity of investing in the capital of other Indian companies or limited liability partnerships ("**LLPs**"), and in core investing companies.

To bring the conditions governing these sectors in line with '*other financial services*', it has now been decided that if any financial sector regulator regulates the activities of such companies, FDI up to 100% shall be allowed under the automatic route. However, if they are not regulated by any financial sector regulator, or where only a part of their activities is regulated, or where there is doubt regarding regulatory oversight, FDI up to 100% will be allowed under the government approval route, subject to conditions including a minimum capitalization requirement, as may be decided by the government.

2.7 Pharmaceuticals

Presently, the definition of '*medical device*' as provided in the FDI Policy is subject to the definition as provided in the Drugs and Cosmetics Act, 1940. It has now been decided that the definition '*medical devices*' shall no longer be subject to the Drugs and Cosmetics Act, 1940. A revised definition of '*medical devices*' is also proposed to be introduced in the amended FDI Policy.

2.8 Regulatory changes

The following are the other regulatory changes pursuant to the proposed amendments:

- In case of investment under the *automatic route* from a country of concern (currently being Pakistan and Bangladesh) requiring approval only on account of the investment being from such a country, FDI applications will now be processed by the Department of Industrial Policy & Promotion for government approval (which, prior to the amendment, was the Ministry of Home Affairs). However, investment under the government approval route from a country of concern, which also requires security clearance, will continue to be processed by the concerned administrative department or ministry.

- The FDI Policy does not have any provisions in respect of specification of auditors who can be appointed by Indian companies receiving FDI. The amendment provides that if a foreign investor wishes to specify a particular auditor or an audit firm, with an international network, for the Indian investee company, then an audit of such an investee company should be carried out as a joint audit wherein one of the auditors should not be part of the same network.

3. INDUSLAW VIEW

The approval of 100% FDI under the automatic route with respect to SBRT is a significant amendment. Global players who previously obtained approval for 100% FDI in SBRT spent substantial time and effort going through the process for FDI clearance under the government approval route. The SBRT sector, now being permitted under the 100% automatic route, is expected to boost FDI inflow in the country.

Relaxing the criteria with respect to sourcing requirements is expected to bring relief to companies sourcing goods from India to maintain parity with their global standards and operations. The amendment to the SBRT regime is expected to provide a huge impetus to the sector. The sourcing requirement was often seen as a major stumbling block for companies engaging in SBRT, and the relaxation comes as a welcome change.

With the anticipated privatisation of Air India to go ahead later this year, permitting the prospect of foreign ownership of up to 49% with governmental approval is a sensible step forward in broadening the class of potential bidders with the necessary industry expertise to restructure the debt-laden airline.

Further, the amendment to the FDI Policy with respect to sectoral limits applicable to companies engaged *only* in the activity of investing in the capital of other Indian companies or LLPs, and in core investing companies, is expected to clear the confusion which has persisted for quite some time.

The FDI Policy allowed FDI up to 100% in companies engaged only in the activity of investing in the capital of other Indian companies or LLPs, and in core investing companies, but only with prior government approval.

However, 100% FDI under the automatic route was allowed for companies falling within the sector of '*other financial services*', which was regulated by financial regulators. This led to an anomaly, where pure investment companies required government approval despite being regulated by the Reserve Bank of India, whereas other regulated financial services did not require such an approval.

The amended FDI Policy intends to align the FDI Policy relating to such companies with '*other financial services*'. The amendment clarifies that companies engaged *only* in the activity of investing in the capital of other Indian companies or LLPs, and in core investing companies, can now receive FDI under the 100% automatic route, if a financial sector regulator regulates such companies.

Other amendments, such as the approval of 100% FDI under the automatic route in real estate broking services, and allowing FIIs and FPIs to invest by way of primary investment in power exchanges, are also aimed at increasing the inflow of foreign exchange into the country.

These efforts of the government have helped the country move up by thirty places in the World Bank's report on the *ease of doing business*, to feature in the list of the top 100 countries in terms of the *ease of doing business* rankings this year.

Authors: Winnie Shekhar, Aakash Dasgupta and Shweta Adhikari

Practice Areas: Corporate & Commercial, Fund Investment, Government & Regulatory, Mergers & Acquisitions

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