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Enhancement of foreign direct investment in defence

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Background

In a recent notification[1] issued by the Department for Promotion of Industry and Internal Trade (DPIIT), Ministry of Commerce and Industry, the applicable limit on Foreign Direct Investment (FDI) in the defence sector was reviewed. Under the revised policy, FDI limit in defence manufacturing under automatic route has been raised from 49 to 74 per cent.

FDI up to 74 per cent automatic route shall be permitted for companies seeking fresh Industrial Licenses (IL). Beyond 74 per cent, individual proposals shall still be evaluated and approved based on access to modern technology and other reasons to be recorded.

Investors in the defence sector need to satisfy certain important conditions like:

- Investee company should be structured to be self-sufficient in areas of product design and development. The investee/joint venture company along with manufacturing facility, should also have maintenance and life cycle support facility of the product being manufactured in India. **(existing condition)**
- Foreign Investments in the Defence Sector shall be 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. **(new condition)**.

In order to liberalise the FDI policy while preserving national security interests, additional conditions have been imposed in tandem with the enhanced FDI limit. The newly introduced conditions include a scrutiny on grounds of national security. The government has also reserved the right to review any foreign investment in the defence sector which affects or may affect national security.

Analysing the fine print

DPIIT's notification classifies defence investment up to 74 per cent (for products requiring IL) under the non-approval or automatic route. However, on a closer reading of the provisions, it may be inferred that a form of approval shall still be required. Investment under automatic route has been permitted only for those companies which are seeking fresh industrial licenses. Such a license will be issued only after consultation with the Ministry of Defence and the Ministry of External Affairs and a thorough background check.

Infusion of fresh foreign investment up to 49 per cent, in a company not seeking industrial license or which already has the government approval for FDI in defence, shall require mandatory submission of a declaration with the Ministry of Defence in case change in equity/ shareholding pattern or transfer of stake by existing investor to new foreign investor for FDI up to 49 per cent, within 30 days of such a change. For existing defence companies seeking to increase investment beyond the erstwhile limit of 49 per cent, a government approval shall still be applicable.

1. Notification 4 (2020 series) dated 17 September 2020, issued by DPIIT, MCI, FDI Policy section

For a better understanding of the amendments, we have summarised the applicable policy for existing and proposed investors in defence in the table below:

S. No.	Existing Position	Proposed Investment (in defence manufacturing not requiring IL)	Applicable Policy
1	IL not applicable	Investment up to 100%	Automatic route
S. No.	**Existing Position**	**Proposed Investment (in defence manufacturing requiring IL)**	**Applicable Policy**
2	No existing investment in Defence (Fresh IL to be obtained)	Investment in defence up to 74%	Automatic route
		Investment in defence beyond 74% up to 100%	Government approval route
3	Existing investment up to 49% (IL already obtained; no fresh IL required)	Investment in defence up to 49%	Automatic route – Government to be informed of change in equity/shareholding patterns
		Investment in defence beyond 49%	Government approval route

Defence Acquisition Procedure - Interplay with FDI Policy

The draft Defence Acquisition Policy, 2020 (DAP), has also been aligned with these FDI guidelines.

- A newly proposed category – Buy (Global - Manufacture in India) has been introduced wherein subsidiaries of Foreign Original Equipment Manufacturers (FOEMs) shall be allowed to execute part of the projects even if they are awarded to FOEMs
- For an entity to qualify as an 'Indian vendor', additional conditions of "ownership and control by resident Indian citizen(s)" existed in a previously released draft of the policy. Subsequently, the FDI limit for defence sector under the automatic route was proposed to be hiked from 49 per cent to 74[2] per cent. To address the dichotomy, the latest draft of the policy has done away with the additional conditions of ownership and control and now permits companies complying with the FDI regime to qualify as an 'Indian vendor', thereby permitting companies which are compliant with extant FDI to be eligible as 'Indian vendor'.

There exist certain categories of procurement like 'Make' and 'Strategic Partnership' which mandate Indian control and ownership. Therefore, FOEMs who wish to participate in acquisitions under these categories still need to restrict their FDI participation to 49 per cent. Investors desirous of leveraging the enhanced FDI limit shall be debarred from participating in such acquisition programmes.

Investment beyond 74 per cent

The new policy has not introduced any modification/ amendment in the procedure for approving FDI proposals beyond 74 per cent. Investment up to 100 per cent is allowed in the sector under the prevailing government approval route wherever it is likely to result in access to modern technology or for other reasons to be recorded.

The extant policy does not contain any guidelines on how proposals beyond 74 per cent shall be evaluated or the definition of what is 'modern technology'. Due to lack of clarity in the policy and lack of precedents in this space, FDI beyond 74 per cent still seems far from being a reality for foreign investors anytime soon.

Will this be a game changer?

Prima facie, increase in FDI to 74 per cent under automatic route is a very positive measure and has been an ask of the overseas players for a long time. This will benefit the sector in expediting inflow of fresh investment and technology. Foreign Defence Manufacturers including tier-1 and tier-2 vendors shall now be able to exercise ownership and control in Indian ventures which was earlier a key area of concern particularly from an Intellectual Property (IP) protection standpoint. Hopefully, this should give Foreign Defence Manufacturers including tier-1 and tier-2 vendors the required reassurance and push to invest in India for proprietary technology.

Also, the revised definition of 'Indian Vendor' and the intention of the Indian Government to promote its 'Make in India' initiative by even allowing subsidiaries of foreign companies to participate in those programmes should provide the business case to further foreign investments into the country.

2. PIB release dated 16 May 2020 - Highlights of Finance Minister's Stimulus Package – IV detailing the measures for easing economic hardships triggered by the Covid 19 pandemic

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