

## Foreign Direct Investment Policy 2014: Status Quo for the Defence Sector

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The Department of Industrial Policy and Promotion (DIPP) has released the Consolidated Foreign Direct Investment (FDI) Policy for 2014<sup>1</sup>. It is effective from 17<sup>th</sup> April 2014. There is nothing new in the policy for the defence sector, if one takes into account DIPP's Press Note 6 of 2013, issued on 22<sup>nd</sup> August 2013<sup>2</sup>.

Needless to say, 'Defence' continues to figure in the list of the sectors in which FDI is allowed to the extent specified in Chapter 6 of the policy, subject to the applicable laws, regulations and other conditionalities.

The policy had been to allow FDI up to 26 per cent through the 'Government route'<sup>3</sup> till DIPP's Press Note altered the status quo by permitting FDI beyond that limit with the approval of the Cabinet Committee on Security (CCS) on a case-to-case basis, wherever it is likely to result in access (whatever that might mean) to 'modern' and 'state-of-art' technology in the country. The 2014 policy merely reiterates this.

While the change brought about by the Press Note was in keeping with what MoD had been saying for a long time, neither the MoD nor the consolidated policy has addressed the issues associated with the decision to selectively relax the FDI limit. It is a bit disappointing as there was plenty of time to do so between the release of the Press Note and the consolidated FDI policy.

The primary issue, of course, is as to what does the term 'state-of-art' mean and what will be the process of determining whether an FDI proposal meets this requirement.

According to the procedure introduced through the aforesaid Press Note and reproduced in the 2014 policy, applications seeking permission for FDI beyond 26 per cent will, in all cases, be examined additionally by the Department of Defence

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<sup>1</sup> Accessible at [http://dipp.nic.in/English/Policies/FDI\\_Circular\\_2014.pdf](http://dipp.nic.in/English/Policies/FDI_Circular_2014.pdf)

<sup>2</sup> Accessible at [http://dipp.nic.in/English/acts\\_rules/Press\\_Notes/pn6\\_2013.pdf](http://dipp.nic.in/English/acts_rules/Press_Notes/pn6_2013.pdf)

<sup>3</sup> According to the definition given in the policy, 'Government route' means that investment in the capital of resident entities by non-resident entities can be made only with the prior approval of the Government [Foreign Investment Promotion Board (FIPB), Department of Economic Affairs (DEA), Ministry of Finance (MoF) or the Department of Industrial Policy & Promotion (DIPP), as the case may be].

Production (DoDP) in the Ministry of Defence (MoD) from the point of view particularly of access to the ‘modern’ and ‘state-of-art’ technology.

With no internal guidelines for processing the requests and no transparent yardstick for assessing whether the offered technology is ‘modern’ and ‘state-of-art’, it might take DoDP for ever to take a decision on such requests. In the areas in which technology keeps changing very fast, what is ‘state-of-art’ today may not remain so by the time the investment starts showing results. Therefore, those assigned the responsibility of making the assessment may find it difficult to take a decision for fear of being unfairly blamed subsequently for not taking a correct view as regards the state of the technology. There would inevitably be an element of subjectivity in making the assessment of the state of technology.

This arrangement also leaves the Defence Research & Development Organization (DRDO) – arguably a better judge of the state of the offered technology – out in the cold. It may be recalled that the offset guidelines of 2012 attach a great importance to acquisition of technology by DRDO. The guidelines even specify the critical technologies and offer a multiplier of 3 for transfer to such technologies to DRDO. But with DoDP now being made responsible for assessing whether the technology being offered is ‘modern’ and ‘state-of-art’, MoD will face the challenge of ensuring coordination between these two departments, for coordination with DRDO, and perhaps even with the services, will be inevitable.

All this could make it difficult to adhere to the stipulation in the policy that the government decision on applications to FIPB for FDI in the defence industry sector will normally be communicated within a time frame of 10 weeks from the date of the acknowledgement.

Secondly, the aforesaid Press Note did not indicate the upper limit on FDI in cases where it is accompanied by access to modern and the state-of-art technology in the country. This led to speculation in some circles that there was to be no cap on FDI if it resulted in access to ‘modern’ and ‘state-of-art’ technology. The 2014 policy does not clarify the position in this regard, though, when seen in its entirety, the policy does not support such speculation.

One of the provisions in the policy – not a new one, though – is that in the Information & Broadcasting and the Defence sectors, where the sectoral cap is less than 49 per cent, the company (the obvious reference is to the entity receiving the FDI) would need to be ‘owned and controlled’ by resident Indian citizens and Indian companies, which, in turn, are owned and controlled by resident Indian citizens – a virtual impossibility anyway.

This seems to effectively cap FDI in defence, even in those cases where it might potentially result in access to modern and state-of-art technology, to 49 per cent. If this understanding is correct, it is doubtful that the foreign companies would be queuing up to bring in FDI in the defence sector in India as it does not make much

of a difference in terms of control on the management of the Indian entity. It would be desirable for MoD and/or the DIPP to review this entire imbroglio and make the position clear.

An important highlight of the 2014 policy is reiteration of the ban, imposed through the aforesaid Press Note, on investment by the Foreign Portfolio Investors (FPIs) and Foreign Institutional Investors (FIIs) (through portfolio investment). Apparently, there had been some cases in the past in which such investment was allowed. The 2014 policy protects the past investment as it provides that FPI/FII (through portfolio investment) investment in companies holding defence licence as on 22<sup>nd</sup> August 2013, i.e. the date on which the aforesaid Press Release was issued, will remain capped at the level existing as on that date.

But it also adds that no fresh FPI/FII (through portfolio investment) will be permitted even if the level of such investment falls below the capped level subsequently. While this will assuage the anxiety of the entities that had received such investments in the past to some extent, the question is whether the stipulation that no fresh FPI/FII will be permitted is implementable. How will the companies ensure this? And, most importantly, what is sought to be achieved by this?

Judging by the way Press Note 6 has been mechanically incorporated in the consolidated FDI Policy of 2014, it seems the FDI policy is destined to remain quiescent for a long time to come in so far as the defence sector is concerned, unless there is an immediate realization that there are a number of issues – some of which are highlighted above - that come in the way of its potential, although rather limited, being realized.

*Views expressed are of the author and do not necessarily reflect the views of the IDSA or of the Government of India.*