

## DEFENCE: KEY CHANGES IN THE REGULATORY LANDSCAPE PURSUANT TO ATMANIRBHAR BHARAT

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The Government of India has been very active in putting in place the necessary framework to implement the objectives of the 'Atmanirbhar Bharat Abhiyan'. The 'Atmanirbhar Bharat Abhiyan' or a program of self-reliance announced by the Government of India intends to focus on the five key pillars of economy, infrastructure, system, vibrant demography, and demand. The program focusses on India achieving strategic self-reliance in key areas to reduce external dependencies which tend to be unreliable even in the best of times. One of the key focus areas of the Government of India has been achieving such strategic self-reliance in defence. This article briefly describes the various steps taken by the Government of India in this regard.

Very briefly, three key changes have occurred since July 2020 vis a vis the defence sector – (a) changes to Foreign Direct Investment regime, (b) promulgation of the 'Defence Acquisition Procedure 2020' (including revamped Offset Guidelines); and (c) some new programs to encourage investments in defence sector.

### Changes to the foreign direct investment regime

- The Government has issued Press Note 4 of 2020 on 17 September 2020 in terms of which foreign direct investment ("FDI") up to 74% is permitted under the automatic route in the defence sector. The earlier FDI limit was 49% under the automatic route.
- FDI beyond 74% and up to 100% is also permitted under the government approval route wherever it was likely to result in access to modern technology or for other reasons to be recorded.
- A key condition is that foreign investment in the defence sector is subject to security clearance by the Ministry of Home Affairs as per guidelines of the Ministry of Defence.
- Another key condition is that the Indian company (whether JV or the WOS) should be "self-sufficient in the areas of product design and development", should have a manufacturing facility and should also have maintenance and life cycle support facilities for the product being manufactured in India.
- There is also an overarching review power available on the grounds of national security. The government reserves the right to review any foreign investment in the sector that affects or may affect national security.
- The intent of the new policy seems to be quite clear that the Government only wants serious players in the sector to look at the Indian market.
- The enhancement of the FDI limit to 74% coupled with the certain other changes to labor laws is a welcome change for foreign investors looking at alternative global options for managing their supply chain requirements.
- Additionally, foreign companies looking to invest in India will find ownership up to 74% more attractive as they will own a majority stake and will give them the much-needed control over

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<sup>1</sup> Views expressed are personal and not necessarily that of the Firm.

the operations and management of the Indian venture. Further, this will help them implement global best practices and governance regimes without much resistance or push back from local partners. Please note that these policy changes to the FDI regime take effect once the relevant exchange control rules are formally amended.

## **Defence Acquisition Procedure, 2020**

The second big development has been the Defence Acquisition Procedure, 2020, dated 29<sup>th</sup> September 2020 (“**DAP**”).

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- Three documents are relevant here – (a) the DAP itself, (b) the new and revamped offset requirements and (c) a list of 101 items which cannot be imported henceforth by the Indian Military from December 2020 to December 2022 has been notified. This list not only contains embargo on simple parts but also on hi-tech weapons and weapons systems. This Embargo 101 list does not mean that foreign players are excluded from selling these products to the Indian defence establishment. They can still set up entities in India to undertake such supply.
- **Definition of “Indian Company”.** The DAP provides that the list of items under the Embargo list can be procured from an “Indian Company”. The definition of an “Indian Company” includes any company incorporated in India. Therefore, subsidiaries of foreign companies are entitled to bid under the categories reserved for the Indian market such as – Buy Indian India Design, Buy Indian and Buy and Make Indian procurements. In an indirect manner, this system encourages foreign players to set up in India and manufacture their products here. It is expected that about USD 60 billion will be spent by the Indian Armed Forces to procure the 101 items over the next 5 – 7 years. The list is already available, so serious foreign players will be encouraged to start thinking of setting up Indian operations to meet the anticipated needs of the armed forces.
- **Exemption from offset requirements.** The Inter-Governmental Agreements have been specifically exempted from offset requirements. This is an important step as India moves away from buying from private suppliers to buying from friendly Governments. Private parties who are sub-contractors to foreign governments stand to gain enormously from this development as meeting the offset requirements and actual offset implementation delays were blamed to be the bane of the Indian defence industry.
- **Leasing option.** Another important development is that for the first time, “leasing” has been introduced in the draft DAP 2020 as a category of defence acquisition in addition to the existing ‘buy’, ‘buy and make’ acquisition categories. Leasing is however not new to India since India has previously leased submarines from the former Soviet Union and Russian previously. The leasing category encourages firms supplying critical equipment and weapons to enter long term/medium term contracts. The contractor would be responsible for maintenance and repair for the duration of the contract. This may be the perfect short-term solution to the highly volatile border situation of India whereby the Indian Armed Forces can possess and operate costly platforms required for a limited period and avoid huge capital expenditure on outright purchase.
- **Transfer of Technology.** The Government has also identified a list of 49 technologies for Transfer of Technology (TOT). Previously, grant of offset credits for TOT was subject to buyback conditions. That is, the foreign vendor was required to undertake a mandatory purchase of products from its Indian TOT partner. Further, offset claims for non-equity investments were also restricted to a percentage of subsequent buyback. A significant change

proposed in the DAP is the enhanced viability of Transfer of Technology (TOT) and non-equity investment as modes for discharge of offset obligations. The non-equity route is proposed to be merged with the equity route, making full offset credits available to vendors subject to verification. Similar provisions have also been issued for the TOT route.

- **Information Communications and Technology.** A new chapter on Information Communications and Technology (ICT) acquisition has been introduced in the DAP. The IP in the ICT systems would however belong to the buyer of the products. India and Indian IT companies have already established themselves globally as being the best in the IT industry. Now, foreign companies which supply IT to Armed Forces as well as home grown IT companies will gain immensely since this category has now been recognised as a procurement avenue leading to more investment and employment in the IT sector.

### **New Initiatives**

- **Encouragement to “start-ups”.** The ‘Innovations for Defence Excellence (iDEX) framework, was launched by Department of Defence Production, with the aim to achieve self-reliance and to foster innovation and technology development in Defence and Aerospace Sectors by engaging Industries including MSMEs, start-ups, individual innovators, R&D institutes and academia. The projects or problem statements are identified based on the requirements projected by the armed forces and certain other stakeholders involved in the defence ecosystem. According to publicly available information, 58 iDEX winners have so far been identified for 18 problem statements/challenges under three rounds of Defence India Start-up Challenge (DISC).
- **Establishment of defence corridors.** The Government has also unveiled plans to establish two defence corridors at Uttar Pradesh and Tamil Nadu. The Defence Industrial Corridors are expected to encourage indigenous production of defence and aerospace related items and reduce reliance on imports and promoting export of these items to other countries. This is expected to generate direct/indirect employment opportunities and growth of private domestic manufacturers, Micro Small and Medium Enterprises (MSMEs) and Start-ups.