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**Recent Liberalizations in the Defence Sector**

If you have questions or would like additional information on the material covered in this Newsletter, please contact the authors:

By: Seema Jhingan, Partner  
([sjhingan@lexcounsel.in](mailto:sjhingan@lexcounsel.in))

Neha Yadav, Senior Associate  
([nyadav@lexcounsel.in](mailto:nyadav@lexcounsel.in))

**Recent Liberalizations in the Defence Sector**

With a view to boost the domestic defence industry, the Government has recently made certain critical announcements with respect to the offset policy (as contained in the Defence Procurement Procedure (“DPP”) 2013 issued by the Ministry of Defence) (“Offset Policy”) and the foreign direct investment policy (“FDI Policy”) in the defence sector. A snapshot of the same is given below:

**I. Offset Policy - Reinstatement of Services:**

The Offset obligations may be discharged with reference to specified eligible products, and eligible services in accordance with the Offset Policy, but provisions related to ‘services’ were kept in abeyance vide the Ministry of Defence’s Office Memorandum dated May 23, 2013, issued in the wake of the Agusta-Westland Deal. The industry has been since then making representations to the Government to reinstate the eligible services for discharge of the Offset obligations. The Ministry of Defence has recently through its Office Memorandum dated December 7, 2015 reinstated ‘services’ as an eligible avenue for offset discharge as per the following terms and conditions:

- Maintenance, repair and overhaul; up gradation/life extension; and research and development services (from government recognized R&D facilities) have been reinstated.

LexCounsel, Law Offices C-10,  
Gulmohar Park New Delhi 110 049,  
INDIA. Tel.:+91.11.4166.2861  
Fax:+91.11.4166.2862

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- Engineering, design and testing; and software development services have been reinstated, with capping at 20% of the total offset obligation and provision of random audit to verify the value of offset contracts and additional requirement of CMMi certification of minimum 4 and above category for the Indian Offset partners for cases where discharge is envisaged above 5% of the Offset obligation.
- Quality assurance; and training services still continue under abeyance.

These changes have come into force with immediate effect for all RFPs issued on or after the date of issue of this office memorandum. Relevant provisions related to services under the DPP 2006, DPP 2008 and DPP 2011 will also stand reinstated as above. The above reinstatement highlights the Government's focus and keenness to allow the domestic defence industry to benefit from the Offset Policy, which has so far failed to be as effective and productive as initially envisaged and intended by the Government of India.

## II. FDI Liberalizations:

The Press Note 12 of 2015 (dated November 24, 2015) ("PN 12") issued by the Department of Industrial Policy & Promotion ("DIPP"), has brought in the following relaxations in the FDI Policy in the defence sector.

- (i) Sectoral Cap: Doing away with the earlier requirement of obtaining prior government approval, FDI up to 49%, has now been permitted under the automatic route in defence Industry subject to industrial license under Industries (Development & Regulation) Act. FDI above 49% still requires prior government approval (on case to case basis, wherever it is likely to result in access to modern and 'state-of art' technology in the country), but the earlier requirement of additionally seeking approval of Cabinet Committee on Security ("CCS"), has now been done away with.

However, infusion of fresh foreign investment even within the permitted automatic route level (i.e. up to 49%), in a company not seeking industrial license, resulting in change in ownership patterns or transfer of stake by existing investor to new foreign investor still requires government approval. Therefore, foreign investment up to 49 per cent in an existing company that results in the foregoing change will still need prior government approval (even though FDI up to 49% is permitted under automatic route and a new company would be permitted to receive FDI up to 49% without any government approval).

(ii) Sectoral Conditions: Earlier FDI in the defence sector was subject to numerous conditions listed out in the FDI policy such as:

- The applicant company seeking permission for FDI upto 49% should be owned and controlled by resident Indian citizens with majority representation on the board; chief executive officer, chief security officer of the applicant company being resident Indian citizens.
- Applications for FDI up to 49% involving inflows in excess of Rs. 2000 crore to be approved by Cabinet Committee on Economic Affairs (“CCEA”). However, proposals for FDI beyond 49% with proposed inflow in excess of Rs. 2000 crores, which are to be approved by CCS will not require further approval CCEA.
- The licensing authority would satisfy itself about the adequacy of net worth of the non-resident investor taking into account the weapons/ equipment proposed to be manufactured.
- Preference would be given to original equipment manufacturers or design establishments, and companies having a good track record of past supplies to Armed Forces, Space and Atomic energy sections and having an established R & D base.
- Adequate safety & security procedures to be put in place upon commencement of production, subject to verification by authorized Government agencies. The standards and testing procedures to be provided to the Government nominated quality assurance agency, which agency would inspect the finished product and conduct surveillance/ audit of the Quality Assurance Procedures of the licensee. Self-certification would be permitted on case to case basis.
- Purchase preference and price preference may be given to the Public Sector organizations as per guidelines of the Department of Public Enterprises.
- Sale of the items to any entity (other than Government entities under the control of Ministry of Home Affairs, State Governments, Public Sector Undertakings and other valid Defence Licensed Companies) shall require prior permission from the Department of Defence Production, Ministry of Defence.

However, with a view to further streamline the FDI policy, these conditions have been removed by DIPP from the FDI policy, as only the following conditions have been specified/retained in PN 12:

- FDI in the defence sector would be subject to security clearance and guidelines of the Ministry of Defence;

- Investee/joint Venture 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;
- Licence applications will be considered and licences given by the DIPP, in consultation with Ministry of Defence and Ministry of External Affairs.

(iii) Validity of Industrial License: Pursuant to DIPP's Press Note 10 of 2015 (dated Sep 22, 2015), initial validity of industrial license for defence sector has been revised to 15 years further extendable up to 18 years for existing and future licenses.

**Feedback**

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