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Newsletter

Russian FDI process: five tips for the foreign investors

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Dear Ladies and Gentlemen,

While the national security regimes are spreading across the Europe and overseas, the Russian watchdog continues to 'tune' already-existing mechanisms to ensure the overall protection of the national interests of the Russian state. The development of the legislation and practice of the Russian Federal Antimonopoly Service ('FAS Russia'), and the Governmental Commission for Control over Foreign Investments, shows that the FDI process is becoming more complex and even those acquisitions, which usually fall out of the FDI scope, still require the close attention of foreign investors. Violation of the FDI rules often leads to disputing the transactions in Russian courts and imposing restrictions upon voting powers of shareholders of the Russian strategic entities. Below, we would like to provide you with a brief overview of several tricky situations, which should be taken into account while investing in Russian strategic industries.

UBO Disclosure as an additional step of the Russian FDI process

UBO Disclosure is a procedure for disclosing beneficiaries, beneficiary owners and controlling persons of a foreign investor. This was introduced in 2018 by Decree of the Russian Government. The logic of this procedure is that, before acquiring shares in a Russian strategic entity, a foreign investor shall apply to FAS Russia with a UBO Disclosure letter, and following the review period, FAS Russia issues an acknowledgment.

The tricky thing here is that a private investor, who has not disclosed its ultimate beneficial owners to FAS Russia, is regarded as the 'undisclosed' investor, and its status is equated with the status of a 'state-owned' investor. In practice, that means that the 'undisclosed' investor faces lower filing thresholds, when making acquisitions of Russian strategic entities. This is based on the fact that acquisition of control in Russian strategic entities is prohibited for 'state-owned' investors as such. Thus, due to high level of uncertainty, similar rules are applied to 'undisclosed' investors.

For example, if a private investor acquires up to 50% in a Russian strategic entity (or even up to 25% – in a Russian strategic entity using subsoil plots of federal importance and (or) harvesting (catching) of aquatic biological resources), it is not necessary to apply for the pre-transaction FDI clearance. However, this is only true, if such an investor carried out a UBO Disclosure process, prior to the acquisition. If a UBO disclosure is not made, even a minority-stake acquisition will trigger the pre-transaction FDI approval.

As practice develops, the UBO Disclosure becomes an obligatory step to remove the status of a 'state-owned' investor and enjoy the lower-filing thresholds, while failure to perform the UBO Disclosure might trigger a FAS Russia investigation of non-compliance with the FDI rules. Just recently, FAS Russia disputed an acquisition, by "Otkrytie Holding", of control over the Russian diamond-mining company "AGD-Diamonds". This was based on the fact that part of information on the ultimate beneficial owners was hidden by the purchaser, during the review of the deal, back in 2017. The parties are now discussing the possibility of an amicable settlement with FAS Russia.

Beware of FDI rules concerning intra-group transactions

While intra-group transactions are excluded from the filing obligations under most FDI regimes in other jurisdictions, the Russian law does not provide for a similar exemption for the cases when a 'state-owned' investor performs an intra-group transaction, involving a Russian strategic entity.

Furthermore, in the absence of a UBO Disclosure, an 'undisclosed' investor, having the same status as a 'state-owned' investor, cannot perform an intra-group transaction involving a Russian strategic entity, without a pre-transaction approval. That generates a threat for many intra-group restructurings and might lead to formal violation of the Russian FDI rules.

Aggregation Rule

The Strategic Investments Law stipulates that a Russian strategic entity shall be considered to be under the collective control of several independent foreign investors if they, in aggregate, have more than 50% of the voting shares (or in some circumstances, less than 50%, where there is a co-relation of voting rights that gives the shareholders the ability to determine the decisions made by the controlled entity) and they are either 'undisclosed' investors or 'state owned' investors (Aggregation Rule).

Generally, it means that FAS Russia may aggregate together the votes of independent shareholders that have not received UBO acknowledgements. Thus, if 'undisclosed' investors in aggregate hold more than 50% of the voting rights, FAS Russia could consider that those shareholders to have collectively acquired control, in breach of the FDI rules.

'Hold separate' does not work anymore

Considering the lengthy FDI process in Russia, which might in practice take some 6-9 months, the parties to the foreign-to-foreign transactions were often using various mechanisms which allowed closing the global transaction before obtaining the pending FDI clearance in Russia. However, since introduction of amendments to the Strategic Investments Law in 2020, one of such mechanisms has not been working anymore.

By these amendments, the concept of 'acquisition' of voting shares was revised and now it also covers shares that, for example, are pledged, placed with a repo partner, or otherwise temporarily transferred to a third party. This was intended to address previous cases where foreign investors had avoided the clearance procedure, by temporarily placing shares with a third party (or voting rights attached to those shares, while remaining the owner of the title to such shares). In such cases, the owner would not have formally held voting rights, and the shares would not have been considered when calculating the ownership stakes. However, FAS Russia and the Government now take the view that such shares are deemed to be effectively controlled by their owner.

In practice that means that it is no longer possible to apply the described 'hold separate' mechanism, since the purchaser would still be regarded as having control over the strategic asset, even if such asset is temporarily put under the 'hold separate' structure. This approach clearly indicates that FAS Russia constantly monitors the practice of the FDI rules' implementation, and, when identifying any "weak" points, which allow wider interpretation or avoidance of the Russian law, the regulator is tightening the legislative rules immediately.

Currently, the only safe way to allow the global closing, before obtaining FDI clearance, is the carve-out of the Russian nexus, which, as mentioned earlier in this letter, shall be separately assessed on UBO Disclosure, or other notification obligations.

Russian Prime Minister might claim jurisdiction for any transaction

The power of the Russian Prime Minister to claim any transaction to be reviewed under the FDI rules was introduced in 2017. Since then, not so many transactions had fallen under the discretional review. However, for more than three years, this process put significant pressure upon investors.

The Prime Minister may exercise its 'any deal' power any time before the closing of the transaction. Thus, FAS Russia, as the main source of information for the Prime Minister, analyses most of the merger control filings, not only based on relevant competition concerns, but also based on national security concerns, and any transaction, filed with FAS Russia, faces a risk of being transferred to the Prime Minister.

Because the process of the Prime Minister's review is strictly confidential, and FAS Russia does not publish any official statistics, the scope of industries, where the 'any deal' process might be initiated, is still unclear. Herewith, based on available public information, FAS Russia's comments and draft laws, we suggest that the investments into the following Russian entities might trigger the 'any deal' process:

- Suppliers of equipment/services to the large Russian state-owned enterprises;
- Participants of the national or federal projects;
- City-forming enterprises (i.e. companies where the substantial part of the population of the relevant city is employed);
- Entities having dominant position in the Russian market;
- Entities rending satellite communication services in the Russian market, or to the Russian customers;
- Russian strategic entities, even if a transaction does not formally fall under the obligatory FDI approval;
- Entities using subsoil plots, even if these subsoil plots do not have a federal importance status.

Currently, it does not seem that FAS Russia, nor the Prime Minister, are paying any specific attention to the origin of the investors when applying the 'any deal' procedure. Generally, investors from the EU, US, China, Saudi Arabia, India and other countries may equally fall under the discretional review, when making investments into the above-mentioned Russian entities. At the same time, likelihood of sanctions, in the sensitive industries, should be taken into account.

Summing up, here is a list of questions we recommend considering when planning investments into the Russian strategic industries:

- ☑ Depending on a particular transaction structure, private investors might need to perform UBO Disclosure, to be qualified as the 'disclosed' investors prior to completion of the transaction
- ☑ Minority acquisitions and intra-group transactions do not automatically fall outside of the Russian FDI scope, so they need to be checked out additionally
- ☑ The Aggregation Rule is quite new, and we are not aware of any published cases, in which this rule has been applied. Herewith, while acquiring a minority stake in a Russian strategic entity, a foreign investor shall assess if there might be some other 'undisclosed' investors
- ☑ The list of the statutory strategic activities does not always enable making a clear conclusion on the strategic status of the Russian target. Business activities of the Russian entity need to be checked out for potential risks of triggering 'any deal' process
- ☑ Closing a global deal, before obtaining the Russian FDI clearance, bears the risks of declaring the transaction void and depriving the shareholder of its voting rights of the Russian strategic entity. Elimination of the Russian nexus by way of carve-out is the only safe way to ensure global closing, without violation of the Russian FDI rules

Our Brochure on FDI rules, containing detailed information on Russian FDI triggers and review process, is available here.

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