

Foreign Direct Investments (FDI) in Russia

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Introduction and Background

FDI regime in Russia was established more than a decade ago, when the Federal Law "On the Procedure for Foreign Investments in Companies Having Strategic Importance for the National Security and Defense" No. 57-FZ dated April 29, 2008 ("Strategic Investments Law") came into force. The Strategic Investments Law establishes the procedure for securing FDI clearances for the transactions, as well as the post-closing notification procedure for the transactions implemented in different strategic sectors of the Russian economy.

Pursuant to the provisions of the law and regulations, the Federal Antimonopoly Service ("FAS") as well as the Government

Commission on Monitoring Foreign Investments chaired by the Prime-Minister of Russia ("Commission" or "Government Commission") are authorized to exercise control over foreign investments in Russia, where the Commission shall decide on granting clearance for the transaction and the FAS acts as an intermediary between the applicant and the Commission.

The current note provides an overview of the legal regime for foreign investments in the strategic sectors of the Russian economy, existing procedure for obtaining FDI clearance and highlights recent trends and legislative amendments enacted just recently by the Russian regulators.

Legal Framework

Acquisition by a foreign investor of shares (interest) or other forms of control (both direct and indirect) in respect of Russian companies having strategic importance ("Strategic Companies") might be subject to clearance with the Russian state authorities under the Strategic Investments Law, which is the major law building up the legal framework for foreign strategic investments in Russia. There is also the Federal Law "On Foreign Investments in the Russian Federation" No. 160-FZ dated July 09, 1999 ("Foreign Investments Law"), which we will also describe in more detail in this brochure.

At the same time, there are also decrees and orders laying out the functions of the

Government Commission, a review procedure and analysis of the transactions in Russia such as:

- Decree of the Government of the Russian Federation "On the Government Commission on Monitoring Foreign Investments" No. 510 dated July 06, 2008;
- Decree of the Government of the Russian Federation No. 838 dated October 17, 2009, which establishes certain rules of FDI filings preparation and review;
- Decree of the Government of the Russian Federation No. 1456 dated December 01, 2018, which establishes the rules for disclosure of beneficiaries, beneficial owners and controlling persons.

Scope of the Strategic Investments Law

The Strategic Investments Law:

- establishes the rules for acquisition of shares in the Russian Strategic Companies;
- foresees cases when transactions require pre- or post-transaction notifications with the Government Commission;
- provides a list of 47 strategic activities deemed as being of strategic importance.

The following relations fall within the scope of the Strategic Investments Law:

- acquisition of majority or minority stakes of the Strategic Companies by foreign investors, or a group of persons; **AND (OR)**
- acquisition by foreign investors, or a group of persons, of the fixed production assets of the Strategic Companies, balance sheet value of which is 25% or more of balance sheet value of assets of the transferring company, for the last reporting date, according to its accounting reports; **AND ALSO**
- other transactions or actions as a result of which the control of foreign investors, or a group of persons, over the Strategic Companies is established; minority stakes, which do not lead to establishment of control, might also be captured.

Strategic Company

The Strategic Company is a company incorporated in the Russian Federation, which performs at least one of the 47 activities of strategic importance listed in Article 6 of the Strategic Investments Law.

Strategic Activities / Industries

- Nuclear and Radioactive materials
- Military Equipment
- Aviation and Space
- Oil and Gas
- Natural Resources
- Mining Exploration and Production
- Mass Media and Telecommunications
- Harvesting (catching) of Aquatic Biological Resources
- Coding and Cryptographic Equipment
- Printing and Publishing
- Use of Agents of Infectious Diseases (except for companies engaged into food production)
- Services in Seaports and River Ports
- Services provided by natural monopolies such as:
 - Oil and Gas Pipeline Transport
 - Railroad Transport
 - Services in Airports
 - Water Supply, etc.

Foreign Investors

The following persons are considered as foreign investors for the purposes of the Strategic Investments Law:

- foreign companies and organizations, regardless of having status of a legal entity
- organizations under foreign control, including those incorporated in Russia
- foreign citizens, apatrides (persons without citizenship) having inhabitancy outside Russia, and Russian citizens having dual citizenship
- foreign states*
- international organizations*

**For foreign states and international organizations there is a prohibition on transactions resulting in the establishment of control over the Strategic Companies (with minimal exceptions). The same rules apply to companies, which do not disclose information about beneficiaries (undisclosed investors).*

Exemptions

The following transactions involving the Strategic Companies fall outside the scope of the Strategic Investments Law:

- transactions, in which a foreign investor already possesses more than 50% of voting shares of the Strategic Company prior to the transaction, or if a foreign investor is under control of the company, which already has more than 50% of voting shares of the Strategic Company. This exemption does not apply for the Strategic Companies involved in use of subsoil plots of federal importance or harvesting (catching) of aquatic biological resources (higher ownership threshold shall apply, which is more than 75% of voting shares)
- transactions may fall outside of scope of the FDI regime if it is specifically provided for in the ratified international treaties
- FDI clearance is not required if a purchaser is controlled by:
 - a) the Russian Federation;
 - b) a constituent entity of the Russian Federation;
 - c) a citizen of the Russian Federation, who is a Russian tax resident (excluding Russian citizens having dual citizenship).
- FDI clearance is not required in respect of the Strategic Companies involved in use of subsoil plots of federal importance or harvesting (catching) of aquatic biological resources in case the Russian Federation has more than 50% of their voting shares and retains this right after the transaction.

“Controlled Person” in accordance with the Strategic Investments Law

1. According to the provisions of Article 5 of the Strategic Investments Law, the Strategic Company is considered being under control (**controlled person**) of a foreign investor, a group of persons (**controlling person**) in case at least one of the following criteria is met:
 - the controlling person has a right, directly or indirectly, to dispose of **more than 50% (25% and more** for the Strategic Companies involved in use of subsoil plot of federal importance or harvesting (catching) of aquatic biological resources) of voting shares of the controlled person;
 - the controlling person on the basis of the contract, or on other basis, acquired the rights, or powers, to determine the decisions made by the controlled person, including terms and conditions of implementation of business activity by the controlled person;
 - the controlling person has the right to appoint an individual executive body and (or) **more than 50% (25% and more** for the Strategic Companies involved in use of subsoil plot of federal importance or harvesting (catching) of aquatic biological resources) of the collegial executive body of the controlled person and (or) has an unconditional opportunity to choose **more than 50% (25% and more** for the Strategic Companies involved in use of subsoil plot of federal importance or harvesting (catching) of aquatic biological resources) of the board of directors (supervisory board), or other collegial managerial body of the controlled person;
 - the controlling person carries out powers of a management company of the controlled person.
2. Please note that the controlled person is considered being under control of the controlling person also in case the controlling person has the right, directly or indirectly, to dispose on any ground of **less than 50% of total voting shares** of the controlled person, provided that the ratio between the number of shares held by the controlling person and other shareholder enables the controlling person to define the decisions made by the controlled person.

3. The control is also established in situations, when foreign states, international organizations, undisclosed investors, and also organizations which are under their control, collectively hold **more than 50% of voting shares** of the Strategic Company (or less for the cases provided in the previous point).
4. Herewith, foreign states, international organizations, undisclosed investors, and also organizations which are under their control, are not entitled **to establish control** over the Strategic Companies or to carry out the transactions providing acquisition of fixed production assets of the Strategic Companies, the balance sheet value of which **exceeds 25%** of balance sheet value of assets of the transferring company, for the last reporting date, according to its accounting reports.
5. Transactions, as a result of which the foreign states, international organizations, undisclosed investors, or organizations under their control, receive the right to dispose of, directly or indirectly, **more than 25% of voting shares** of the Strategic Company, or other opportunity to block decisions of managerial bodies of the Strategic Company, or have the right, directly or indirectly, to dispose **more than 5% of voting shares** of the Strategic Companies involved in use of subsoil plot of federal importance or harvesting (catching) of aquatic biological resources, are not deemed as establishment of control, however these transactions are still subject to FDI clearance.

Undisclosed Investors

The Strategic Investments Law has a concept of “**undisclosed investors**”. In accordance with the law, these are companies, which do not disclose information about their beneficiaries, beneficiary owners and controlling persons. The legal status of such companies is equal to public investors (foreign states and international organizations), for which the special regulation is established (for example, lower thresholds for FDI clearance or prohibition to establish control over the Strategic Companies).

Accordingly, application of a stricter regime can be potentially avoided by providing the required

information regarding beneficiaries, beneficiary owners and controlling persons of a foreign investor (including those registered in offshore jurisdictions) (“UBO Disclosure”).

UBO Disclosure may be done both within the FDI filing and, if it is necessary to disclose this information for confirmation that the FDI filing is not triggered (to avoid lower threshold), within a separate document/procedure for such disclosure prior to completion of the transaction (in practice, 1-2 months prior to completion). Proper UBO Disclosure has been becoming vital for validity of transactions in the Russian strategic sectors.

Foreign Investments Law

Foreign Investments Law provides for additional (separate) type of the filing procedure. It may be triggered where: (i) the acquirer directly or indirectly receives more than 25% of any Russian incorporated companies or rights to block the decisions of their management bodies; and (ii) the acquirer is under control of a foreign state or international organization.

Accordingly, this type of a filing does not require Russian companies to implement “strategic types of activities” and is dependent on the type of a foreign acquirer (private or public one). Generally, this filing is quite straightforward and serves as an additional mechanism for the FAS to check that transactions of public investors do not need to be referred to full FDI review neither

because the acquired Russian company is the Strategic Company, nor because the Prime Minister wants to use it discretionary right to refer “any” transaction to full FDI review. This filing

ends up with the letter from the FAS that the filing is not subject to full FDI review. Practically it may take up to 1-2 months.

Pre-Transaction and Post-Transaction Notifications

The Transactions subject to FDI clearance could be divided into those requiring pre- and post-transaction notifications:

Pre-transaction notifications

Pre-transaction filing is necessary for establishment of control and other transactions with voting shares (including certain minority acquisitions) and with rights, or acquisition of fixed production assets of the Strategic Company.

Post-transaction notifications

Post-transaction notification shall be filed in case of acquisition of 5% and more of the shares in the Strategic Companies as well as in case of closing those transactions that received pre-transaction FDI approval.

Filing Procedure and Documents Required

For the **pre-transaction notification**, a foreign investor shall obtain consent of the Government Commission prior to implementation of the transaction. Preliminary proceedings are held by the FAS and other state bodies.

The review procedure consists of three stages:

- The notification is reviewed by the FAS, which checks on compliance of the notification with the formal requirements.
- Then, the FAS sends out requests related to the notification to other government authorities including those being in charge of state security and national defense.
- Finally, the Government Commission reviews the notification along with the reports provided by the specified government authorities and adopts a decision.

As in the case with merger control clearance, for the FDI filing very much similar information and documents are required.

The review period constitutes about **3 months**. It could be additionally prolonged for up to **3 months**. Practically, the review period may take even **longer**.

The **post-transaction notification** shall be submitted to the FAS within 45 calendar days from the date of closing of the transaction.

Then, it should be reviewed within 30 days from the date of submission of the relevant documents. Upon the results of the review of the notification special notice shall be granted.

Decisions of the Government Commission

The Government Commission may adopt one of the following decisions:

- to refuse in clearance of the transaction
- to give a consent to the transaction
- to give a consent to the transaction, imposing certain obligations on the purchaser

Merger Control Issues

As a rule, the notification and approval requirements in the FDI regime are separate from the merger control regime provided for by the Competition Law. However, where transactions require clearance under both

regimes, the FAS will suspend the merger control review until the FDI clearance is obtained. If a transaction is blocked under the FDI regime, this automatically constitutes the ground for the competition authority to deny merger clearance.

Sanctions

Importance of obtaining FDI clearance cannot be overestimated since its violation may result in invalidation of the transaction, or deprivation of the foreign investor of his right to vote at the general meetings of shareholders of the Strategic Company.

Transactions executed in breach of the Strategic Investments Law are null and void. If it is impossible to apply the consequences of invalidity of a void transaction, the court may, upon the lawsuit of the FAS adopt a decision to:

- deprive a foreign investor of its right to vote at the shareholders' meeting of the Strategic Company;
- invalidate the decisions of the management bodies of the Strategic Company adopted after establishment of control in breach of the Strategic Investments Law.

Moreover, according to the Russian Code on Administrative Offences administrative fines are to be imposed in case of failure to obtain FDI approval, or to notify after the transaction and for submission of misleading information to the authority.

Failure to comply with the requirements above may result in the imposition of the following fines:

- For pre-transaction clearance - up to **RUB 1 000 000** on companies
- For post-transaction notification - up to **RUB 500 000** on companies

The most frequent violations are related to failure to submit post-transaction notifications, or information required for consideration of the notifications.

Statistics and Notable Cases

10-years statistics¹:

- 516 notifications submitted
- 206 notifications returned, since clearance was not required, and 47 withdrawn by the applicants
- 229 considered, of which: 216 cleared (63 conditional approvals) and 13 rejected
- others were being reviewed

Landmark rejections

- Acquisition of 100% shares of the Russian power company, Electroshield Samara, by Schneider Electric (France)(2012);
- Acquisition of 100% shares of the Russian pharmaceutical company, NPO Petrovax Pharm, by Abbot (USA) (2013);
- Acquisition of 50% of shares of the Fashion Press, publishing Cosmopolitan and Esquire in Russia, from Sanoma by Hearst Shkulev Media (partially owned by Hearst (USA)) failed to clear (2015).

Challenging of transactions

- In the **Astrakhan Port case**, the FAS initiated court proceedings against Khazar Sea Shipping Lines, South Shipping Agency, Azoress Shipping Company L.L.FZE (all indirectly controlled by Islamic Republic of Iran) with respect to the acquisition of Astrakhan Port JSC shares by those companies, in violation of the Strategic Investments Law. The court agreed with the FAS and invalidated the transaction, making the foreign investors return the shares to the Seller. After a number of attempts to appeal the decision, the companies settled with the FAS and sold the shares to another company, which had obtained FDI clearance.
- In the **Perm Port case**, the court found that a series of interconnected transactions—through which the shares of a Russian strategic company were purchased by several separate companies and an individual, all of whom acted for the benefit of one British investor—were made to “establish control” “of a foreign investor over the [Russian] company having strategic importance” and that such a scheme constituted grounds for invalidity
- The FAS filed a lawsuit to the court challenging the transaction for the purchase of **AGD Diamonds**, a big Russian producer of diamonds, by Otrkytye Promyshlennye Investitsii from PAO Lukoil. The transaction had received FDI clearance. However, the FAS found out that the applicant had not provided the information on foreign citizenship of a number of its beneficiaries during the review of that transaction.
- In the **Specialized Seaport Vitino case**, the FAS found that the High Court of Justice in London had appointed citizens of the United Kingdom as temporary managers for the Cyprian company Yuzarel Investments Limited. The specified temporary management obtained rights to exercise operational management of the company and to determine the decisions of its subsidiary - Seaport Vitino, being the Strategic Company. FDI clearance, required for such actions, was not received. The FAS asked the Russian court to invalidate the decisions of Yuzarel and to deprive it of its voting rights. Yuzarel concluded a settlement agreement, transferred 100% of shares to a Russian company and thus, deprived itself of control.

¹ The statistics as of April 27, 2018, available here: <https://fas.gov.ru/p/presentations/145> (in Russian only)

“Any Transactions” that might be referred to FDI clearance

Upon the decision of the Russian Prime Minister, any transactions of foreign investors with regard to Russian entities, which do not even relate to the specified 47 types of strategic activities, might be brought to the Government Commission for FDI clearance under the same procedure specified in the Strategic Investments Law.

There are no legal criteria clarifying, which transactions could fall within this procedure. According to the law enforcement practice, the following types of transactions might be of interest of the Russian Prime Minister and referred to the **Government Commission** (not excluding though other types of transactions that might become of interest for the state authorities):

1. Transactions in respect of Russian companies not involved in implementation of the strategic activities, however, implementing activities that might be connected with those 47 activities of the strategic importance;
2. Transactions involving Russian companies important for the economy (participants in national projects, city-forming enterprises, companies having a dominant position in a certain market, suppliers of equipment/services to the large Russian state-owned enterprises, entities using subsoil plots, etc.);
3. Transactions involving a Russian company, where such a company is the only supplier (manufacturer) of products in the market, where others are foreign ones;
4. Manufacturers of specialized civilian products that can be used for military purposes;
5. Transactions involving the Strategic Companies, when thresholds for FDI clearance are not met.

Obligations

When, after the consideration process, the **Government Commission** has concerns that the transaction might affect the national defence and security of the state, it could elaborate commitments/obligations to be imposed on the parties to the transaction to mitigate the risks

The procedure for adoption of the decision by the **Prime Minister** is as follows:

1. Within 5 business days from the date the FAS becomes aware of the transaction of a foreign investor with respect to the Russian company, it shall send out requests, on the necessity to inform the Russian Prime Minister, to the federal authorities, or organizations, responsible for implementation of national policy and statutory regulation in the considered sphere, into which the Russian entity is involved.
2. Simultaneously, the FAS notifies the foreign investor on necessity to suspend the transaction until the decision about the transaction is taken;
3. After that, within 15 business days, addressees shall submit their suggestions to the FAS;
4. In case the Russian Prime Minister adopts a decision on the necessity to get FDI clearance, the FAS shall inform the foreign investor of the decision taken within 3 business days.

and negative impact of the transaction. Such obligations might include limitation of access to the state secrets, maintenance of production facilities, fulfillment of defense procurement supplies and so on. The list of **obligations is not exhaustive**.

Our Experience

ALRUD Law Firm specialists have a vast experience in FDI consulting across the full range of context and different sectors of economy. A brief description of some of notable and recent examples is provided below:

- **CEFC China Energy Company Limited**

In FDI clearance with the Government Commission of the acquisition of 14.16% of shares in Rosneft Oil Company.

- **Siemens AG**

In merger control and FDI clearance of its merger with Alstom S.A. valued at \$ 17 billion.

- **Natura &Co**

On obtaining FDI and merger control clearances for the acquisition of Avon Products, Inc.

- **One of the world's largest investment funds**

In court proceedings regarding a lawsuit, filed by FAS Russia, alleging violation of the Strategic Investments Law in relation to one of the largest Russian metallurgical plants.

- **VimpelCom**

In FDI clearance with the Government Commission regarding the acquisition of an IT outsourcing company.

- **Large telecommunication company**

In giving an expert opinion to a US court, on issues related to clearance of its M&A transaction in accordance with Russian merger control and FDI regulation.

- **Global drilling contractor**

In litigation with FAS Russia in the state commercial courts, the Supreme Court and the Constitutional Court of the Russian Federation. FAS Russia did not approve the acquisition of the Russian company claiming that the deal should have received FDI clearance.

- **China National Gold Group**

On FDI issues of the acquisition of a controlling stake in the company operating in subsoil plots of federal importance. The acquisition was based on an intergovernmental agreement between Russia and China.

- **French aerospace, space, defence and security group**

In the acquisition of a digital identity and security group, assisting our client with successful receipt of FDI and merger control clearances.

- **Gold mining company**

On antitrust and FDI risks associated with acquisition of shares within corporate conflict.

- **Five largest world's investment funds**

Within simultaneous legal support on proper disclosure of their beneficiaries prior to closing. This was to prevent risks under the Strategic Investments Law. We also assisted with preparing and supporting post-closing notifications.

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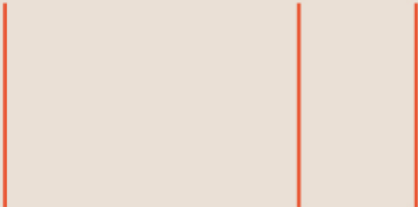
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