Foreign investments in strategic sectors in Russia
Alex Stoljarasky, Attorney, Beiten Burkhardt

Alex Stoljarasky
Alex Stoljarasky is a Senior Associate with BEITEN BURKHARDT law firm in Moscow, which he joined in 2006 and an attorney admitted at the District Court of Berlin. After graduating from the University of Bayreuth with a degree in law (2002) and in economics (2003) he completed legal traineeship at the Higher Regional Court of Berlin and worked with the German Ministry of Foreign Affairs in Tashkent and in New York City. Alex is an active member of the German-Russian Chamber of Commerce and since 2007 deputy chairman of the Legal Committee of the Association of European Businesses in Russia. In this function he participated in the legislative process of drafting the Law regulating foreign investments in strategic sectors in Russia at the State Duma and published numerous articles related to foreign investments in Russia. Alex's clients include large and medium-size corporations in the automotive, health-care, machine engineering as well as media sector where he advises in Corporate law, M&A and Joint Venture projects. He is also supporting Russian clients in expanding their business towards Germany.

Siemens AG selling a major shareholding to a Chinese state fund, Gazprom sold to an American investor and EADS to a Brazilian company? You will find that many people are afraid of even contemplating such developments. Owing to concerns about the specific influence of foreign capital, in particular the politically motivated leverage of economic might, legislators all over the world have been taking steps that not only provide immediate protection against the (alleged threat posed by) foreign state funds, but also make it harder for foreign investors to access strategic sectors of the domestic economy in general.

In May 2008, a law signed in Russia “On the Procedure for Foreign Investments in Business Entities of Strategic Importance for National Defense and State Security” (“the Law on Strategic Investments” or “the Law”) established prescriptions stipulating that foreign investments may only be made in specific sectors of the Russian economy deemed particularly important after preliminary approval has been obtained from a Government Commission.

I. MAIN PROVISIONS

The law cites three premises for its application: If (1) a foreign investor (or group of entities, which applies to foreign legal entities and individuals) (2) intends to establish control over (3) a Russian enterprise conducting a strategic important activity, it should obtain prior approval for this transaction from a Government Commission, which is chaired by the Prime Minister. Pursuant to clause 1 of article 15 of the Law, a legal transaction performed in violation of the obligation to obtain such consent is null and void.

1. Foreign investor (or group of entities)

a) The concept of “foreign investor” is used in the meaning specified in article 2 of the Law “On Foreign Investments” (“The Law on Foreign Investments”). For the purposes of the Law on Strategic Investments, as foreign investors shall be likewise recognized organisations controlled by foreign investors, including those established in the territory of the Russian Federation. To date, the Government Commission has in a number of cases issued a specific decision in respect of Russian enterprises under the control of a foreign enterprise (more often than not the resident of an offshore zone), where Russian individuals were the ultimate beneficiaries of these offshore structures. Nevertheless, it has been held that a foreign investor actually acquired this interest.

b) Incidentally, far more issues have arisen in law and enforcement practice in connection with the use of the concept of “group of entities” applied to a foreign investor. Pursuant to clause 3, article 3 of the Law on Strategic Investments the definition provided in article 9 of the Law “On the Protection of Competition” (“Law on Competition”) is used in respect of the concept of group of entities.

Pursuant to this article, a group of entities is understood to mean individuals or legal entities that are perceived as a single subject of law ow-

1 Federal Law No. 57-FZ dated 29 April 2008

2 Federal Law No. 160-FZ dated 9 July 1999

3 Federal Law No. 135-FZ dated 26 July 2006
ing to their affiliation, based on the criteria specified in article 9 of the Law on Competition. It was aimed to prevent attempts to circumvent the law, when a transaction to acquire an interest is not concluded by a foreign investor, but instead by a Russian company being part of the group of entities (for example, a company specially established for this purpose).

However, arbitrage courts, which have so far only ruled on isolated cases associated with the Law on Strategic Investments, have interpreted the Law verbatim and consider a group of entities as a "foreign investor" even if the foreign legal entity or individual included in the group of entities does not play a direct or indirect role in the transaction and is actually itself under the control of the Russian legal entity or individual.

Scheme 1: Investment thresholds

<table>
<thead>
<tr>
<th>Company – acquisition target</th>
<th>Investor</th>
<th>State foreign investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>General enterprise of strategic importance</td>
<td>The approval is required if over 50% is acquired (in certain circumstances also if a smaller interest is acquired)</td>
<td>The approval is required if over 25% is acquired, while the acquisition of over 50% is prohibited</td>
</tr>
<tr>
<td>Enterprise, which develops subsoil plots of federal importance</td>
<td>The approval is required if 10% or more is acquired (exception: the Russian Federation owns over 50%)</td>
<td>The approval is required if 5% or more is acquired, while the acquisition of over 50% is prohibited</td>
</tr>
<tr>
<td>General enterprise (that is not strategically important)</td>
<td>There are no restrictions on investments, unless otherwise specified in a special law</td>
<td>The approval is required if 25% or more is acquired</td>
</tr>
</tbody>
</table>

Such a broad interpretation no longer complies with the goals of the Law, as in this case every Russian enterprise with a foreign subsidiary is obligated to secure approval from the Government Commission for investments in strategically important sectors. Furthermore, new opportunities have arisen to utilize the Law; this happened within the framework of the privatization program of the former monopoly RAO UES (United Energy Systems): citing the Law, certain Russian corporations were able to successfully default on their obligations before shareholders, after they had already forwarded to minority shareholders so-called mandatory offers on the purchase of shares.

In the meantime, the Federal Antimonopoly Service (FAS) and the Russian Government became aware of this issue and introduced corresponding draft amendments to the Law (see point IV below.)

c) In addition, the Law on Strategic Investments splits foreign investors into private and state investors. The latter are subject to more stringent rules for acquiring participation interests. The term "state investors" also applies to organizations that are directly or indirectly controlled by a state.

2. Establishment of control

The issue of establishing control over an acquisition target is a decisive criterion that determines whether the acquisition should be subject to the Law. The following scheme (Scheme 1) indicates when approval must be obtained for an acquisition (approval):

In the case of foreign state investors, including enterprises that are state-controlled, the establishment of control starts in the event of the acquisition of over 25% of the total number of votes attributable to voting shares (interests) in the capital of the company of strategic importance being acquired.

The acquisition of over 50% by a state investor is prohibited. In addition, in accordance with parallel amendments to the Law on Foreign Investments, any acquisition of an equity interest of 25% and above, in other words, even in enterprises that are not of strategic importance, is subject to the approval procedure established for strategically important sectors.

In the case of foreign private investors, it may be held that the investor has established control if its interest exceeds 50%. Incidentally, the actual establishment of control may also be recognized if the level of interest is smaller in special circumstances. In particular, the Law cites an incident where the investor may appoint an executive body or otherwise have a specific influence on the adoption of decisions at the company. In the case of companies listed on an exchange, where a large number of shares are freely traded, it may be held that an investor has

---

established control, even in cases where it has an interest of far less than 50%.

Consequently, the assessment as to whether an investor has established control as a result of the planned legal transaction will depend on the actual facts and will be considered on a standalone basis in each specific case.

Special rules apply to enterprises, which use subsoil plots of federal significance. In this case the establishment of control is stipulated if the foreign investor intends to acquire 10% or more (for state investors: 5%). Certain exceptions are only permissible in cases, where the Russian Federation owns an interest of over 50%.

3. Strategic sectors
The Russian legislator decided to provide an exhaustive list of 42 types of activities that are of strategic importance for the country’s defense. They are focused in the following sectors of the economy:

- Nuclear power;
- Data encryption technologies;
- Military technologies;
- Space exploration and aviation;
- Periodical print industry, television and radio broadcasting, and also telecommunications;
- Natural monopolies⁶;
- In addition, the law applies to the commercial fisheries sector; and
- Activities stipulating the use of bacteria and other agents of infectious diseases.

More stringent rules are applied to organizations that want to use subsoil plots of federal significance⁷ (in other words, major deposits). At the same time as the approval of the Law on Strategic Investments, amendments were introduced to the Law “On the Subsoil”⁸. They establish, inter alia, threshold limits for subsoil plots of federal significance.

At first glance, the list of sectors would appear to have clearly defined boundaries. However, it has little bearing on the actual facts. It soon transpired that investments in banks (in connection with licenses to use data encryption technologies) by necessity fall within the purview of the Law. Authorities were urged starting to apply a simplified screening procedure to this sector. Another consequence: in order to acquire dairy plants or breweries, which naturally acquire licenses to use bacteria, or to acquire a clinical institution, where X-ray equipment is used, the purchaser must apply to the Government Commission.

The on-going reform discussion and the draft law amendments submitted by FAS to the Government in May 2010, rectify these issues (see point IV. below)

However, a number of issues still remain unresolved. For example, does the production and installation of ventilation systems, which are used both at nuclear reactors and also, for example, in office buildings, constitute an activity of strategic importance based on the meaning provided by article 6 of the Law on Strategic Investments?⁹

It should be noted here that a whole concern is subject to the law if it is involved in strategic activities, even where the volume is immaterial. Consequently, even insignificant activities by a subsidiary or granddaughter company will lead a potential investment project to be considered strategically important.

4. Preliminary request in accordance with clause 6, article 8 of the Law on Strategic Investments
Clause 6, article 8 of the Law on Strategic Investments grants the foreign investor the right, if it has any doubts over the establishment of control, to file a preliminary request with FAS, in order to clarify whether the approval procedure is required. As was indicated previously, it is frequently the case in practice that the following issues raise concerns – not only the establishment of control, but also whether the applicant is actually a foreign investor, and also whether the acquisition target is an enterprise of strategic importance. The FAS is aware of these issues and accepts that such requests may be filed in connection with this fact as well¹⁰, although the Law does not give such competence to FAS. Naturally, such an approach is to be welcomed, but it would be better to introduce the respective legal ground by corresponding amendments to the Law.

When submitting a preliminary request, the applicant should attach detailed information on corporate, legal and other aspects of its affiliations, and also on the types of activities of the applicant. The FAS should verify, within 30 days, whether the applicant should in this case undergo the approval procedure and send its decision as well to the Government.

---

⁶ Federal Law No. 147-FZ dated 17 August 1995 “On Natural Monopolies”.
⁷ See the list of subsoil plots of federal importance dated 5 March 2009, in the version dated 13 August 2010.
¹⁰ So explicitly Tsyganov, AEB Business Quarterly (Winter 2010/2011), page 7 (11): “That is, you can turn to us in order to determine: whether you are a foreign investor; whether control is obtained as the result of a deal; whether the object of the deal is strategic in nature.”
Commission. No investment, however, shall be taken until the Government Commission indeed takes notice of the FAS decision by way of confirmation, otherwise one is running the risk that the Government Commission shares another view on the intended transaction. As far as known to the author, this happened already twice and the FAS had to revoke its earlier decision. Therefore, it may be often more secure to file directly for Governmental approval.

5. Obligation on notifying FAS pursuant to article 14 and clause 3, article 16 of the Law on Strategic Investments

An interest of less than the controlling shareholding does not require the receipt of preliminary consent. It goes without saying that, in accordance with article 14 of the Law, the investor should notify FAS on any acquisition of five or more percent of shares (interests) in business entities of strategic importance within 45 days of said acquisition. Furthermore, in accordance with clause 3, article 16, each foreign investor was obligated to provide information within 180 days of the entry into force of the Law on the interests that it already held in the capital of an enterprise of strategic importance of 5% or more.

II. APPROVAL PROCEDURE

The FAS is the competent authority for the acceptance of petitions from foreign investors on approving the establishment of control by the Government Commission. In addition to the information on corporate, legal and other aspects of its affiliations, and also on the types of activities of the applicant, it is necessary to submit the agreement, which discloses the content of the proposed transaction, and also the business plan of the enterprise of strategic importance.

2) The FAS registers the petition and checks the documents. If the investments are prohibited in accordance with clause 2, article 2 of the Law on Strategic Investments, as it would establish the control of a foreign state investor, the documents are returned to the applicant – see clause 4, article 9 of the Law on Strategic Investments. If the Law is not applicable, as the foreign investor does not establish control as a result of the acquisition, FAS returns the documents in accordance with clause 2, article 9 of the Law on Strategic Investments. In this case, there are no obstacles to the investment.

3) In all other cases, FAS transfers the documents to the Federal Security Service, and where necessary to the Inter-Departmental Commission for the Protection of State Secrets, and requests an opinion. In addition, depending on the specific sector of the economy, the findings of corresponding ministries and departments are requested.

4) After receiving all responses, FAS prepares a draft decision and transfers it with all other documents to the Government Commission. In accordance with clause 1, article 12 of the Law on Strategic Investments, the Government Commission may, in addition to the issue of refusal or consent, also provide its conditional consent, subject to the applicant’s discharge of specific obligations (for example, the preservation of jobs or maintenance of specific production sectors, the continued discharge of specific state orders, etc.). The Government Commission adopts its decision during meetings, which are as a rule held once a quarter. In accordance with clause 4, article 11 of the Law on Strategic Investments, the duration of the screening procedure should not exceed three months since the actual registration of an application at FAS. This timeframe starts to be counted as of the filing of all the requisite documents. The FAS has the right of first assessment to said filings and may request additional documents, if it believes that they are required to obtain a complete idea about the planned transaction, acquisition and ultimate beneficiary (beneficiaries).

In exceptional cases, the decision-making term may be extended for another three months. In practice, there have already been instances, where the maximum term allowed by the Law was exceeded; however, no sanctions or other legal consequences are stipulated if this term is exceeded. This could obviously have an adverse impact on the transaction schedule of the foreign investor.

5) The Law only contains only indirect indications on the criteria, which serve as guidance for the decisions adopted by the Government Commission. In addition, the Government Commission does not have to substantiate its decisions, which complicates any effective legal defense before the Supreme Arbitration Court (clause 7, article 11 of the Law on Strategic Investments). To the best of knowledge, to date not a single decision of the Government Commission has been subject to a judicial review.

11 By Government Resolution No. 510 dated 6 July 2008 "On the Government Commission on Control over Foreign Investments in the Russian Federation", FAS was recognized as the so-called "competent authority".

81
III. PRACTICAL IMPLICATION OF THE LAW

The following figures reflect the influence of the Law on the international transaction practice on the expiry of 2.5 years after its entry into force:

- 189 petitions on approving the establishment of control (including 143 within the framework of the Law on Strategic Investments, 46 within the framework of the Law on Foreign Investments),
- 424 notices on the acquisition of 5 or more percent of enterprises of strategic importance (including 276 in accordance with clause 3, article 16 of the Law on Strategic Investments and 148 in accordance with article 14 of the Law on Strategic Investments),
- 58 preliminary requests under clause 8, article 6 of the Law on Strategic Investments;
- 242 enquiries from foreign investors, enterprises of strategic importance, federal executive authorities and other departments in connection with the interpretation and application of the Law on Strategic Investments. The large number of enquiries indicates that a lot of issues remain unclear when it comes to practical application of the Law.

The 189 petitions on approving the establishment of control over an enterprise of strategic importance can be broken down into the following sectors (Scheme 2):

![Scheme 2: Relevance of Strategic Sectors](image)

- Use of the subsoil of federal importance
- Cryptography
- Natural Monopolies
- Television, radio broadcasting and the print industry
- Other types of activities

Investments in commodities (oil, gas and other natural resources) account for the vast majority of all the cases. Furthermore, 21% of the cases concern activities relating to the development, production or use of encryption technologies (banks account for 14% of the total). This is followed by investments in the mass media and natural monopolies. It follows from here that a large number of sectors have played to date a subordinate role or have played no role at all. In total, 36 out of 42 strategic activities regulated under Art. 6 of the Law were relevant yet.

The FAS considered directly 75 out of the 189 received petitions on approving the establishment of control within the scope of its established competence:

- 18 petitions in respect of credit institutions were considered pursuant to the simplified screening procedure;
- 57 petitions were returned to the applicants in accordance with clause 2, article 9 of the Law on Strategic Investments based on the fact that control was not established;

Within the framework of nine meetings of the Government Commission (as at December 2010) 66 petitions were considered, inter alia:

- 53 were approved unconditionally;
- 5 were dismissed;
- 8 were approved, subject to the applicant's agreement to discharge obligations in accordance with clause 1, article 12 of the Law on Strategic Investments (in six cases FAS concluded corresponding agreements with foreign investors, in two cases foreign investors renounced these obligations and the signing of corresponding agreements).

IV. DISCUSSION ON REFORMS

The FAS, with the participation of the AEB Legal Committee among others, has developed proposed reforms and submitted them to the Government. To all intents and purposes, the State Duma will consider the amendments to the Law in Spring 2011. In accordance with the submitted proposals, the application of encryption systems will still have strategic importance. However, an exception will be made for banks in this area. The use of bacteria classified as fairly safe, and also the application of equipment with insignificant radioactive emissions, will also be removed from the area of application of the Law. In addition, it is intended to define the concept of a

---

12 Figures according to the Head of Department for Control over Foreign Investments of FAS Russia, S. Levchenko, presented at a Round Table discussion on January 27, 2011 in Moscow, see www.inkorp.ru/seminars/moscow/investicii_2010/#6

13 Publicly accessible information on exact number of dismissals is contradictory. Some sources state that only in two cases the Government Commission dismissed petitions. The figures presented here rely on the presentation of Levchenko, (see footnote 12).
group of entities more clearly to eliminate the aforementioned inconsistencies.

Furthermore, the amendments specify that no additional approval is required to increase the charter capital of strategically important enterprises, which use subsoil of federal importance, if the increase does not result in an increase in the total number of votes of the foreign investor.

The remaining proposals concern primarily procedural aspects, and also clarify some grounds for action by FAS.

These amendments are desirable and necessary. However, we have been waiting for a long time for declared concessions for foreign investors making investments. Consequently, during continued debate of the reform, there are increasing calls to raise the threshold for investments in the development of subsoil plots of federal importance and thereby provide broader access to foreign capital. Such a decision would certainly result in the liberalization of the Law, which would represent a significant move forward.

It remains at the moment, most likely, wishful thinking that the approval procedure itself will be significantly shortened in time and that the amount of documents and comprehensive information to be provided may be reduced. By elaborating a simplified and more time efficient approval procedure both the Russian State as well as foreign investors would benefit from the stimulation of foreign direct investment flow.