Federal Law No. 57-FZ “On the Procedure for Foreign Investments in Business Entities of Strategic Importance for National Defense and State Security (“Strategic Investments Law « or «the Law”) allows a foreign investor to establish control over a Russian enterprise conducting activities in a strategically deemed sector only after preliminary approval has been obtained from a Government Commission.

Actual implementation of the Law, since it came into force in 2008, as well as restrictive court practice, caused concern and criticism among foreign investors. In a bid to liberalize the Law, a number of amendments were introduced by Federal Law No. 322-FZ, which came into force on 18 December, 2011.

I. Basic provisions of the strategic investments law

1. Foreign investor (or group of entities, which includes a foreign investor)

a) The concept of «foreign investor» is used in accordance with the definition provided in Federal Law No. 160-FZ “On Foreign Investments” (“The Law on Foreign Investments”). Organizations controlled by foreign investors, including organizations established in the Russian Federation, are likewise recognized as such. The Strategic Investments Law distinguishes between foreign private and foreign state investors. The latter are subject to more stringent rules in respect of the acquisition of participation interests. The term “foreign state investor” also applies to organizations that are directly or indirectly controlled by a foreign state.

The concept of “group of entities” is used in accordance with the definition provided in Federal Law No. 135-FZ “On the Protection of Competition”. A group of entities is understood to mean individuals or legal entities that are perceived as a single subject of law owing to their affiliation, specified by certain criteria.

2. Establishment of control

a) The establishment of direct or indirect “control” over an entity of strategic importance is a key criterion for determining whether the acquisition should be subject to the Law. One of the following serves as indicia of control:

- the purchase of a “controlling interest” (usually more than 50%);
- the right to select the single executive body of a company and/or at least half the members of a collegial executive body or of the board of directors;
- the right to control the company’s decisions by other means.

In respect of a foreign state investor, approval is required if the proposed transaction will result in the right to manage, either directly or indirectly, 25% participation interest of the company of strategic importance. The acquisition of over 50% by a foreign state investor is prohibited.

b) Special rules apply to enterprises, which use subsoil plots of federal significance (in other
words, major deposits). In this case, the establishment of “control” is now stipulated if the foreign private investor

- intends to acquire 25% participation interest or more
- or
- receives the right to appoint 25% or more of the members of the collegial executive body or the board of directors).

Certain exceptions are only permissible in cases where the Russian Federation owns an interest of over 50%.

While the former threshold for foreign private investors was significantly increased from 10% to 25% for, the threshold of 5% for foreign state investors remained unchanged.

3. Operating in a strategic sector

The Law on Strategic Investments lists 42 different types of activities that are deemed of relevance in strategic sectors such as:

- Nuclear power;
- The use of subsoil plots of federal significance;
- Data encryption technologies;
- Military technologies;
- Space exploration and aviation;
- Periodical print industry, television and radio broadcasting;
- Telecommunications;
- Natural monopolies;
- Activities stipulating the use of bacteria and other agents of infectious diseases;
- Commercial Fishery;
- Performance of work, which actively influences hydrometeorological and geophysical processes and conditions.

Both fishery and operations with hydrometeorological and geophysical processes represent sectors that have not been affected to date.

Most of the filed petitions (as of November 2011) concern investments in commodities (oil, gas and other natural resources), followed by activities related to encryption, radio and television, and also natural monopolies.

Most of the activities mentioned in the Law require a license according to the Federal Law No. 99-FZ «On Licensing Certain Activities.» Accordingly, the Strategic Investments Law states that a license to engage in an activity in a strategic sector is a sufficient criterion for the Law to apply. In these cases it is irrelevant whether turnover or market share in respect of the strategic type of activity are material or not. The possibility that such activity can (will) be performed, is sufficient.

II. Sanctions in case of a violation

A legal transaction performed in violation of the obligation to obtain preliminary approval is null and void. Adopted decisions are held to be invalid. The parties to a transaction have to restore the original state of being, which could cause certain problems in practice.

The foreign investor forfeits the right to vote at a Russian strategic company if the transaction was performed abroad and cannot be declared void in accordance with Russian law.

The recent reform of the Law “On the Protection of Competition” (the so-called 3rd Antimonopoly Package), effective from 7 January 2012, introduced amendments to the Russian Code on Administrative Offenses. Now a fine is stipulated for the lack of approval in the amount of 500,000 to 1,000,000 rubles (and also for the non-submission or submission of false information further to a request from the Federal Antimonopoly Service – FAS)

III. Consequences for foreign investors

Any participation of a foreign investor in a strategic company in the amount of 5% and more has to be declared to FAS within 45 days. According to the latest amendments to the Russian Code on Administrative Offenses, a fine is payable for the late submission of a declaration in the amount of 250,000 to 500,000 rubles.

A company may decide to implement certain reorganizational measures (e.g. separation from the “strategic” part of the company, if this part of the business is not of interest to the foreign investor) prior to the conclusion of an agreement on the purchase of a controlling interest. However, if the strategic part of the company is separated solely for the purpose of avoiding the application of the Law, FAS holds the position that in such cases it will want to review the deal and collect information. This is all the more so, if the renewal of the strategic activity in future appears possible. It remains unclear, however, which criteria is used by FAS to determine whether the separation from the strategic activity occurred definitively or only temporarily.

Another practical consequence is that the deadline for the adoption of a decision by the Government Commission (three months – or in exceptional circumstances six months) only starts to be counted as of the complete submission of all documents. Numerous petitions filed at present are incomplete. FAS may demand additional documents in order to clarify all the facts of the case or the relations of the participants and identify the final beneficiary.
Within the framework of a Due Diligence, it is necessary to verify at the beginning of the transaction structuring whether the Strategic Investments Law is applicable.

A share purchase agreement should contain a condition precedent regarding the receipt of approval from the government commission. The agreement should also stipulate provisions for instances where such consent is not received.

It may well be impossible to quantify how many deals have been put on hold – or abandoned – as a result of this legislation. At the same time, however, despite the positive outcome of the decisions adopted by the Government Commission so far (Status as of November 2011), where 129 out of 137 filed petitions were approved and only eight were dismissed, one should not ignore the fact that the adoption of decisions on investments and capital flows into the Russian economy has slowed in recent years. The approval process (let the significant costs for legal advise aside) can take so long that an envisaged deal loses its economic appeal and momentum, while at the same time, a vast amount of information (as well as confidential company secrets) has to be submitted by the applicant to the federal authorities.

IV. Reform of the strategic investments law

1. Exclusion of international financial institutions

International financial organizations established in accordance with international treaties, of which the Russian Federation is a member or International financial organizations with which the Russian Federation has concluded international contracts, are now excluded from the application of the Law. This amendment was long awaited and does not provoke any further questions.

Government Resolution No.119-p dated 3 February, 2012 approves the list of international financial organizations excluded from the Law. This includes for example:

- International and European Banks for Reconstruction and Development;
- International Bank for Economic Co-Operation;
- International and European Investment Banks;
- Black Sea Trade and Development Bank;
- Eurasian Development Bank, etc.
2. New threshold values for the use of natural resources

The aforementioned increase in the threshold for enterprises in respect of the operation of subsoil plots of federal significance – from 10% to 25% of votes attributable to voting shares (interests) and the right to appoint now up to 25% (instead of 10%) of the members of the collegial executive body or the board of directors was also a long-awaited change, which will serve stimulating foreign investments in this area. This change can indeed be cited as a significant liberalization of the Strategic Investments Law and deserves to be recognized as such.

3. Approach to “purely Russian” legal transactions

An exception is further made for transactions concluded between companies under the control of the Russian Federation or Russian citizens. This refers to companies and Russian citizens that are deemed Russian residents in accordance with Russian legislation on taxes and duties (with the exception of Russian citizens, who have dual nationality). However, in the adopted version, this rule actually exempts foreign investors under the control of the Russian Federation or under the control of citizens of the Russian Federation and has no bearing on foreign investors that are not under such control.

Let us assume that this norm, which was introduced by Presidential Decree, has a different meaning and that the word «between» refers only to the control of the acquiring side, and also, that this provision was possibly intended as a solution to issues arising from a very controversy court practice relating to the definition of «group of entities, which include a foreign investor».

If a foreign investor under the control of a Russian beneficiary, in respect of subsoil of federal significance, can also be implemented without the prior approval of the Government Commission.

Consequently, this rule removes the administrative barriers preventing the beneficiaries from withdrawing Russian assets in offshore accounts, which is at loggerheads with the position of the government, which wants to reduce the possibility of transferring assets to offshore jurisdictions.

FAS is already aware of difficulties in this regard and is currently working on amendments to these newly introduced amendments which means that we may soon expect further developments in regulating relationships and agreements within a group of entities, which include a foreign investor.

4. Exclusion of certain activities previously deemed strategic

As mentioned earlier, owing to the verbatim interpretation of the Law by the authorities and courts, the Law was applied in situations where national security and defense were not endangered in any way.

Consequently, the legislator decided to rule out certain activities. In future, a foreign investor does not have to undergo the approval procedure if the investor acquires a controlling interest in an enterprise that uses equipment that issues insignificant radioactive emissions in the civilian sector, unless it is the main area of activity of the acquisition target. Medical institutions that use such devices (e.g. X-Rays) are herewith finally excluded from the application of the Law.

The application of encryption systems will continue to be of strategic importance. However, an exception will be made for banks in this area, as the use of encryption technology is not a core activity itself for banks, but is essential for the provision of certain financial services.

Contrary to general expectations, the use of bacteria in the food industry sector classified as fairly safe was not excluded, as the Head Physician of the Russian Federation opposed said exclusion. However, FAS states that it is continuing work in this area, as acquisitions of dairy plants or breweries, which naturally acquire licenses to use bacteria and

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currently fall under the Law, are not a target of the Strategic Investments Law.

5. Other innovations

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.

Most of the other innovations concern primarily procedural issues and have no effect on the overall approval process. It is worth mentioning here, however, that if the Government Commission approves a deal under certain conditions, which have to be fulfilled by the foreign investor, FAS can now conclude a corresponding agreement with the foreign investor that regulates its obligations without forwarding the agreement for a second time to the Government Commission for approval. Officials claim that this will reduce the whole process significantly, taking into account the fact that the Government Commission meets approximately once every three months.

V. Evaluation

At first glance, the list of activities in strategic sectors would appear to have clearly defined boundaries. However, the list of activities contains a different level of detail, which leads to varying interpretations among market participants, the state officials involved and naturally the courts. This also results in uncertainty and unpredictability, which contravenes the explicitly stated goal of providing clear “rules of the game” for foreign investors.

We can still identify instances where the Strategic Investments Law has not been harmonized with the Law “On Licensing Certain Activities” in respect of certain types of activities. For example, while activities in the nuclear power sector requiring a license are named identically as in the corresponding law regulating licensing in this field, activities in the aviation sector or space sector have not been clarified, which provides room for (different) interpretation.

Furthermore, some issues remain unregulated by the Law, but result in certain complications in practice. The establishment of new companies is not regulated in the Law as such. Consequently, it is possible that a foreign-controlled Russian subsidiary performing a strategic activity could be established in future. Verbatim, the Law would not be applicable, as it only mentions instances relating to the “acquisition of a participation interest” and not the incorporation of a fully or co-owned subsidiary.

At the same time, however FAS states that the Strategic Investments Law may be applied during the receipt of a respective license for the performance of “strategic” activities. However, it remains unclear how the Law would be applied in this case, as at present there is no corresponding legal mechanism that would allow for such application.

The inflexible approach on penalty sanctions is another issue that should be reviewed. It is not always in the interests of the Russian Federation to consider every deal performed in violation of the Law as null and void. There could be instances where it would make sense to allow for a post-approval process.

In conclusion, most of the amendments are desirable and necessary. However, we have been waiting for a long time for declared concessions for foreign investors making investments in Russia.

Before introducing amendments to existing legislation to enforce the new legislation, it would be good to see that a comprehensive assessment has been performed in respect of the consequences and impact that such new legislation has on the legislation in force. Such an assessment should be prepared by independent institutions and make it possible to avoid certain contradictions in the legal framework and unexpected results in practice.

It would probably be wishful thinking to assume that the approval procedure per se will be shortened significantly and that the amount of documents and comprehensive information deemed necessary may be reduced. By elaborating a simplified and more time-effective approval procedure, both the Russian State and foreign investors would benefit from the stimulation of the flow of foreign direct investments. Nevertheless, it is good to see that at long last the vast majority of deals reviewed by the Government Commission have been approved. Against the background of the prevailing government policy of modernizing the Russian economy and liberalizing access for foreign investors, we hope to see further changes that make it possible to quickly transfer investments into attractive industries, even if they are subject to the Strategic Investments Law and require a certain level of government attention and review from the perspective of state security.