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RUSSIA: Recent changes in the investment regulation and their effect on the investment climate

The Russian market has for more than ten years been among the most rapidly growing economies in the world and has already gained recognition as an attractive place for portfolio and strategic investors. Development of Russian investment regulation and protection of foreign investors has substantially progressed since the 1990s and although from time to time there have been disputes between the state and certain business groups making national and foreign investors concerned about their prospects such disputes have not really affected the overall investment environment. Furthermore, liberalisation of currency legislation and closer ties between Russian businesses and those in the USA and Western Europe have inspired even conservative American, European and Japanese investors to regard Russian investment opportunities as carrying reasonable risks.

Until recently Russian legislation was characterised by the absence of restrictions or limitations on foreign exposure apart from thresholds for the number of Russian banking and insurance companies owned and controlled by foreign residents. In all other cases there were no official restrictions or prohibitions on the participation of foreign investors in Russian companies, although potentially the Russian anti-monopoly supervisor could reject the approval of certain foreign investments into the equity or management of Russian companies with strategic significance for the Russian state, justifying the refusal on the grounds of potential constraint of competition in the market.

Such a dubious situation could not survive too long and the Russian authorities opted for the establishment of some clear rules controlling foreign ownership of Russian companies and entities operating in those sectors acknowledged as possessing strategic significance for national security and defence. Such rules were stated in the draft law on Foreign Investment in Legal Entities of Strategic Importance to the National Defense and State Security of the Russian Federation, which after several years of public discussion was finally adopted in April this year, coming into force in early May. Within the drafting process the key issue was the list of sectors covered by the scope of the law. The list was eventually finalised with 42 items, including pure national security fields like encryption services and handling of nuclear materials, and further extending to some sectors whose relevance to national defence or security is not that obvious, such as telecommunications companies with a significant share in the market and publishing houses.

Once the law comes into effect any transactions covered by it will be subject to approval by the relevant government bodies, provided that a certain ownership or control threshold is attained as a result of the transaction. The law distinguishes between strategic companies pursuing the exploration and development of strategic subsoil deposits and other strategic entities, where approval is needed for portfolio investments of just 10%, and the other strategic companies, where approval is needed only when a foreign investor purchases a controlling share in their charter capital or similar rights over the management of such companies. In the case when the foreign investor is a foreign state or its wholly owned agency, the threshold is lowered to the 25% or enough to gain blocking rights in all cases and 5% when it comes to strategic subsoil extraction companies.

It should be noted that the law has no retroactive effect and any foreign investors meeting the appropriate threshold who acquired their shares or control prior to the enactment of the law are only expected to make a notification to the government authorities without seeking any additional approvals or consents.

Adoption of the law provoked some confusion about its application, especially when it comes to Russian public companies pursuing the exploration and development of strategic subsoil deposits whose shares in the form of depositary receipts are traded at foreign exchanges. Broad description of some listed strategic enterprises contributed to the concern of foreign investors not being aware whether the target company can be related to the listed ones or not.

However, although the law is sometimes ambiguous and there is no official guidance for its application, its adoption should still not be considered as aimed at the restriction of foreign exposure – on the contrary, it may make more transparent the procedure for the acquisition of control over strategic companies as compared with the previously used methods of rejection by the antimonopoly bodies, sometimes without clear reasons. Systems for controlling foreign participation exist in the majority of developed countries and the introduction of a similar institution in Russia is a similar initiative aimed at setting more predictable rules. Certainly, the law is not yet tested and its practical application by governmental authorities will allow us to see whether the law is actually of a restrictive nature or a more transparent mechanism for the control of foreign exposure, but it should not be considered as a step back in the regulation of investment activities in Russia. ■

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