

A strategic investment

There is a new Russian law on foreign investment in sensitive sectors

by *Peter Pettibone and Alla Naglis**

The new Federal Law of the Russian Federation on Foreign Investments in Companies Having Strategic Importance for State Security and Defence, No 57-FZ – the Law – came into effect on 7 May 2008. It establishes a process of approval allowing foreign investors to make acquisitions in Russia's strategic sectors. However, it is also part of an overall tightening of restrictions on foreign investment in Russia's sensitive assets.

In 2005, President Vladimir Putin, in his message to the Federation Council (the upper house of the Russian parliament), highlighted the idea of controlling foreign investors' access to strategic sectors in Russia. The initial plan was to control (1) strategic subsoil fields through mechanisms introduced in amendments to the existing subsoil legislation; and (2) other strategic areas through the adoption of a separate law. However, in March 2008, these two approaches were consolidated in the draft strategic investment law by expanding it to cover foreign investment in Russia's strategic subsoil fields.

The current version of the Law was introduced in the state Duma (the lower house of the Russian parliament) in the summer of 2007. The first of three readings required to pass the state Duma took place in September 2007. But then there were many debates and arrangements made within the government, involving the presidential administration, the Federal Security Service (FSB), the Federal Anti-Monopoly Service (FAS), the Ministry of Communications and Information Technology, the Ministry of Industry and Energy, the gas monopoly Gazprom, the electrical monopoly RAO UES and others. These resulted in several amendments to the Law before it was presented for the second reading in the state Duma in March 2008. This was the decisive reading. The third reading, largely a formality, took place on 2 April; the Federation Council quickly passed the proposed law on 16 April; and its signature by Mr Putin on 29 April was almost his final act as president. The Law took effect on its official publication on 7 May.

As noted by several observers, the initial draft of the Law envisaged a more liberal regime than the regime that has been established in the final version of the Law.

Brief description of the Law

The Law specifies 42 activities that have strategic significance for national defence and state security. During the heated debates after the first reading of the Law in the Duma, the list underwent considerable change. For example, natural monopolies providing electrical and postal communication services, energy transmission services and electricity supply services were excluded from the list between the first and the second readings of the Law.

Basically, the 42 activities in the Law can now be grouped into eight main areas: (1) nuclear materials, devices, waste, etc; (2) coding and cryptographic equipment; (3) weapons, military equipment and technology; (4) aviation and space; (5)

large-scale television and radio broadcasting and printed mass media; (6) natural monopolies which are designated as such on the FAS list; (7) telecoms, but not internet providers; and (8) geological survey – and exploration and development – of subsoil areas of federal significance.

As regards the definition of “subsoil areas of federal significance”, the list of such areas has not yet been published.

The Law defines the thresholds requiring approval as follows:

- the acquisition of control, including the acquisition of >50% of the voting shares/participatory interests, appointment of the general director or >50% of the board of directors or management board, in a strategic company;
- the acquisition of control, including the acquisition of 10% or more of the voting shares/participatory interests, appointment of the general director or 10% or more of the board of directors or management board, in a company engaged in geological survey, or exploration and development, of a subsoil area of federal significance;
- the acquisition of any subsequent stake in a company engaged in geological survey, or exploration and development, of a subsoil area of federal significance, if that foreign investor or group already controls 10% or more of voting shares/participatory interest in the target;
- the assumption of managing company functions or any other transactions leading to the establishment of control in respect of a strategic company; and
- the acquisition by a foreign state, international organisation or organisation under the control of a foreign state or international organisation of >25% of the voting shares/participatory interests or other blocking right in a strategic company or >5% of the voting shares/participatory interests in a company engaged in geological survey, or exploration and development, of a subsoil area of federal significance. In either such case, the Law prohibits a foreign state, international organisation or organisation under the control of a foreign state or international organisation from acquiring control of a strategic company, including having the power to appoint its general director, its management board or its board of directors.

It is unclear whether unrelated and unaffiliated foreign investors, each independently purchasing less than the requisite percentage requiring approval, will still be grouped together for purposes of determining whether the requisite percentage has been exceeded. A conservative approach suggests that they should be.

The following transactions are exempt from the prior approval requirement:

- Transactions completed before the enactment of the Law.
- Investments in strategic companies engaged in development of subsoil areas of federal significance, where the Russian Federation controls >50% of the voting shares/participatory interests. This exemption, however,

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does not apply to investments made by a foreign state, international organisation or an organisation under the control of a foreign state or international organisation.

- The acquisition of control over companies in which a foreign investor or a group already controls >50% of a strategic company. This exemption does not apply to companies engaged in geological survey, or exploration and development, of subsoil areas of federal significance.

Prior approval process

The applicant is the foreign investor or another person in the foreign investor's group that joins in the acquisition. The term "foreign investor" also extends to companies under the control of the foreign investor, including companies incorporated in Russia. The governmental entity to which the application is sent is referred to in the Law as the Authorised Body. We understand the Authorised Body will be the FAS, but that is not spelled out in the Law, and it is possible that some other agency will be the Authorised Body.

The Law spells out in considerable detail what has to be included as supporting documentation in the materials to be submitted to the Authorised Body. However, until the Authorised Body has been officially designated, it is not possible to submit an application for prior approval.

The duties of the Authorised Body in the Law are to receive and review the application and supporting documents, make a preliminary determination whether approval is required, coordinate the application with the FSB and other governmental bodies who need to have input into the approval process, and present its decision and the supporting documentation to a governmental commission, which will be chaired by the prime minister (now Mr Putin), for the final decision.

The governmental commission's approval can be conditioned on specific obligations to be assumed by the foreign investor. These obligations would be formalised in two documents: the approval issued by the governmental commission and an investment agreement to be entered into between foreign investor and the Authorised Body.

The Law provides for confidential treatment of information that is designated as confidential in the application or in the accompanying documentation.

Timing

The Authorised Body has 14 days to make its initial consideration and circulate the application to the other relevant agencies. Then there is a 30-day period for the Authorised Body to perform a comprehensive check of the strategic company (including licences to carry out strategic activities, access rights to state secrets and permits for dual purpose goods) and for other state agencies to give their input to the Authorised Body before it has to submit the application to the governmental commission. The commission in turn has another 30 days to issue its decision. The entire process of prior approval is meant to take not more than three months, although, in unspecified special cases, it can be extended to six months.

Appeal

A decision by the Authorised Body, or failure by the Authorised Body to act, can be appealed through judicial channels. A

negative decision by the governmental commission can be appealed to the Supreme Arbitration Court.

Notification requirement

The Law also requires that foreign investors acquiring 5% or more of the shares of a strategic company must report the acquisition to the Authorised Body according to procedures to be adopted by the Authorised Body. A foreign investor which had acquired 5% or more of the shares of a strategic company prior to the enactment of the Law must notify the Authorised Body of such acquisition within 180 days.

Penalties

The penalties for violation of the Law include nullification of the acquisition; loss of voting rights; and invalidation of subsequent decisions of the management bodies (and the subsequent transactions) of the strategic company.

Scope of the Law

The Law has extraterritorial application and applies to transactions and agreements executed outside Russia if they result in the acquisition of control of a strategic company by a foreign investor. It operates only prospectively, so that already completed acquisitions are grandfathered, but there is a question whether deals that have been negotiated but not closed are grandfathered. The Law does not cover greenfield projects but, if these are in strategic sectors, they will require separate licensing. It is unclear whether the licensing process in such sectors may be impacted by the restrictions imposed by the Law.

Related legislative changes

At the time the Law was adopted, a number of other laws were amended to conform their provisions to the new statute. These other laws include: the Law on the Subsoil; the Law on the Continental Shelf; the Law on Joint Stock Companies; the Law on Limited Liability Companies; the Law on Investigation Activities; the Law on Foreign Investments; the Antimonopoly Law; and the Law on Communications.

Among other things, these amendments define which natural resource deposits are considered to be strategic and which are not. For example, oil fields containing at least 70 million tons of oil or gas fields containing at least 50 billion cubic meters of gas are defined in these amendments as being strategic.

Conclusion

The new legislation is receiving a mixed reception. On the one hand, once it is operational and issues that are not fully defined in the Law have been worked out, it should give clarity to foreign investors seeking to invest in Russia's strategic sectors. On the other hand, foreign investment in a number of areas which were once thought to be outside the need to obtain prior governmental approval, particularly in the telecoms area, are (or may) now be subject to prior governmental approval. And it remains to be seen whether these approvals will in fact be granted, or whether the tendency of the Authorised Body and the governmental commission, given their broad discretion under the Law and the fact that the criteria for approval are not spelled out in the Law, will be to deny approval of foreign investment in Russia's strategic sectors.