



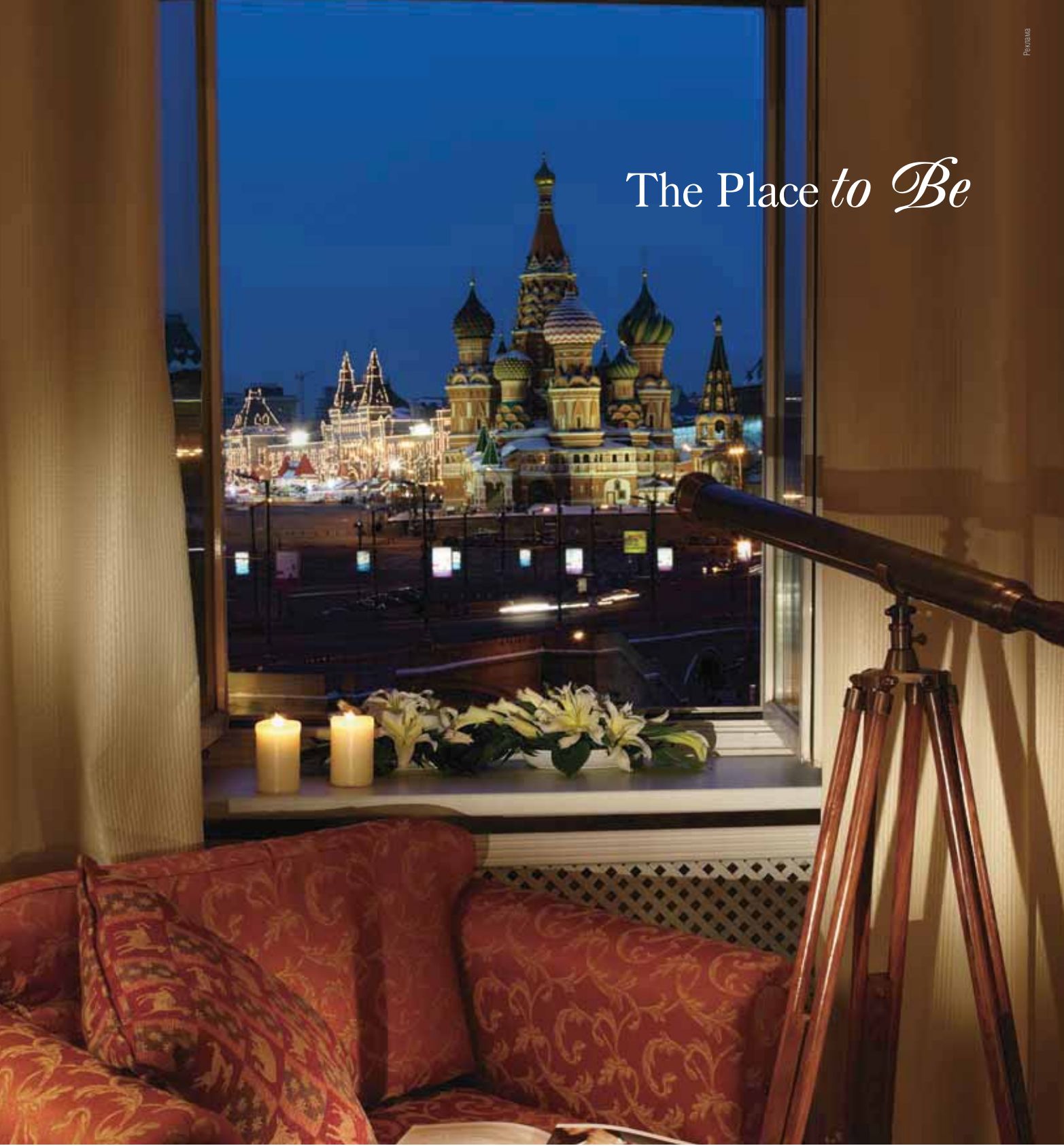
# HOW TO INVEST IN RUSSIA AEB



**The AEB guide to theory and practical advice for making an investment in Russia in 2011**



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## **Foreword by Elvira S. Nabiullina, Minister for Economic Development of the Russian Federation**

**Elvira S. Nabiullina**

Dear Readers,

I am glad to welcome you to yet another edition of the AEB guide on How to Invest in Russia.

For the past several years, this publication has presented many informative articles to help guide people in investing in the Russian economy.

I would like to thank the Association of European Businesses for providing, on a regular basis, updates to the latest changes in Russian legislation. This material helps point out the many new opportunities and advantages to the investment community for running a business in Russia. Also, this information can serve to open the market for potential new investors.

Attracting direct foreign investments is one of our top priorities. That is why the Government of the Russian Federation pays special attention to the improvement of the business environment for all Russian market players.

A number of measures have been taken in 2010: the simplified migratory regulations for foreign highly-skilled specialists was enacted, the customs registration procedure was simplified, tax remissions were introduced, the price for connection to infrastructure was cut, and the wide-scale 2011 to 2015

program for the privatization of state property was adopted in order to reduce the public sector of the economy.

At the beginning of 2011, an outline was put into place to achieve short and medium range goals for a more business friendly environment.

We are ready to assist foreign companies in the establishment of full-cycle manufacturing, deployment of high-tech productions, and promotion of Research and Development divisions for those corporations who operate within Russian territory. With this objective in view our aim is to develop and establish improved systems to meet the demands of an ever changing business environment, and to advance the investment climate in the country as a whole.

We invite companies to discuss the possibilities for Russian based projects. New and exciting opportunities are opening up to manufacture your own hi-tech products in Russia.

I hope this publication will serve as a platform to open such a dialogue.

*E.S. Nabiullina,  
Minister for Economic Development  
of the Russian Federation*

## **Statement from Dr. Christian Ziegler, Chairman, AEB Finance & Investments Committee**



**Dr. Christian Ziegler**

Ladies and Gentlemen,

This is now the fifth edition of the AEB guide – "How to Invest in Russia". A lot has changed in the Russian Federation over this time. We, therefore, also altered the content of the Guide, structuring it in generally three parts: considerations before the investment, considerations after the investment and generally useful information for all readers, including experience of investors, who have already been here for some time.

Russia is the natural partner for investors from Europe, still offering enormous opportunities, fast development and interesting challenges. The business culture is much more similar to European practices than in other BRIC countries or in all the other former states of the USSR.

Still, the Russian specifics have to be obeyed. Considerations regarding investment in the Russian Federation could not start too early. Rules in Russia are different from those in Western Europe. Even when you read the same words in the law, the authorities, your business partners and staff are all likely to interpret it differently. As such, the knowledge of these interpretations and the unwritten rules are of high importance. Market entry will be smooth and successful with the right partners on your side and after solid preparation.

The AEB for more than 15 years now forms a platform to make the market entry for new investors

easier and to give investors already working in Russia, on the one hand, a network for the exchange of information, and on the other hand, representing the interests of its members in negotiations with the Russian Government and authorities. The AEB, being an organization formed by its members, is strictly independent from governmental and political organizations and only committed to the interest of its members. As such, we are well respected by the representatives of the Russian business community and invited by the Russian State Duma, Ministries and high ranking officials of important authorities, as well as representatives of various regions of the Russian Federation to discuss issues of foreign investors in Russia.

I want to thank all authors and all AEB staff who were involved in this process, for the great work that they have done on this publication. Also, we are most grateful for all the articles, written by extremely busy specialists in their fields, writing just to contribute to this project and the mission of the AEB FIC.

We hope this publication will serve its purpose – to bring more investments and reduce the number of surprises while investing in Russia.

If you have any comments and points for discussion, please let us know. We want to grow and get better with each year and include as many ideas for our readers as possible.

*Dr. Christian Ziegler, Chairman,  
Finance & Investment Committee,  
Association of European Businesses;  
Partner, Rödl & Partner Russia/CIS*

## **Statement from Mr. Reiner Hartmann, Chairman of Board and Dr. Frank Schauff, CEO, Association of European Businesses**



**Mr. Reiner Hartmann**



**Dr. Frank Schauff**

Dear Readers,

Welcome to the AEB 2011 “How to Invest in Russia” guide.

In 2008, the world witnessed the financial crisis, considered by some to be the worst in the last 100 years. This was followed by a one year period of recovery, and in 2010, everyone spent the next 12 months taking stock of their losses and bidding their time in hope that the worst was over. At this point in time, one may not be entirely wrong in assuming that the storm is in fact over and the world is ready to move on. But the one thing, which the past years’ events have taught everyone, is that decisions need to be re-evaluated and new strategies made and this includes foreign investment.

High dividends are still high on any investor’s priority list, but now, so is sustainable investment. The World Bank forecasts in its 2011 World Bank Economic Prospects report that the Russian Federation will play a significant part in the economic prosperity of the Commonwealth of Independent States (CIS) region and economic growth will likely stabilise at 4.2 percent in 2011. In addition, in its article “20 Tips for the 2011 Market”, published in January, 2011, The Sunday Times listed Russia

as one place for investors to consider. The Russian Federation has long laid emphasis on foreign investment, and from recent events, it is becoming evident that Russia means business. Already, Pepsico has completed its \$3.8 billion acquisition of a majority stake in Russia’s largest dairy and fruit drink maker Winn Bill Dann and BP has taken a huge stake in state-controlled Rosneft, Russia’s largest oil producer.

Aside from the aforementioned, the truth is, Russia is simply too territorially vast and rich in terms of resources for any multinational corporation to ignore. Russia is a foreign investors dream in terms of potential export: abundant reserves of metals, oil and timber to mention but a few still attract many investors eager to export these products. Also, the country’s population is a beacon for many an investor to seriously consider importation, as the demand for quality goods definitely exists.

This year, in addition to important changes within the investment environment, the guide features a case study, to prove to all interested foreign investors that sustainable investment in Russia is possible and worthwhile.

*Mr. Reiner Hartmann,  
Chairman of Board*

*Dr. Frank Schauff,  
Chief Executive Officer*

*The Association of European Businesses*



**Association of European Businesses  
in the Russian Federation**

**AEB CEO**

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**TABLE of CONTENTS**

**Foreword by Elvira Nabiullina, Minister  
for Economic Development of the Russian Federation . . . . . 1**

**Statement from Dr. Christian Ziegler, Chairman of AEB FIC . . . . . 2**

**Statement from Mr. Reiner Hartmann, Chairman  
of Board and Dr. Frank Schauff, CEO,  
Association of European Businesses . . . . . 3**

**RUSSIA IS THE RIGHT PLACE FOR INVESTING**

**Greenfield vs. Brownfield: What is the right strategy  
for investing within the Russian Federation? . . . . . 6**  
Andre Scholz, Director General, Rödl & Partner

**Regulation of foreign investments into  
the Russian economic entities of strategic importance . . . . . 10**  
Igor Artemiev, Head of the Federal Antimonopoly Service of Russia

**BEFORE YOU START**

**Investing in Russia: Can you afford not to?  
Mark Okes-Voysey, Managing Partner, PricewaterhouseCoopers . . . . . 14**

**Addressing sustainability related risks  
in the emerging business environment . . . . . 17**  
Valery Kucherov, Head of Performance & Assurance Services  
and Elena Amirkhanova, Head of Impact Assessment  
and Planning Services, ERM Eurasia

**Investing in Russia? What to know about tax  
and legal before you go . . . . . 21**  
Alina Lavrentieva, Partner, PricewaterhouseCoopers

**Labor Availability – Russian Peculiarities . . . . . 25**  
Olga Bantsekina, Chief Representative, Coleman Service UK Ltd

**Russia attracts investment through smart immigration policy  
Ludmila Shiryayeva, Director, Human Capital department, Ernst & Young . . . . . 28**

**Certified in Russia . . . . . 31**  
Oscar Ozols, Business Development Director, Sercons

**ISSUES DURING AN ACQUISITION**

**Financing a transaction . . . . . 36**  
Dr. Vladimir Ismailov, CFO, Moscow School of Management Skolkovo

**8 Steps to facilitate better protection against tax risks  
in share purchase agreements when making  
an acquisition in Russia . . . . . 39**  
Andrey Shpak, Tax Partner, Goltsblat BLP

**Key changes to Russian tax law in 2011 . . . . . 41**  
Andrey Shpak, Tax Partner, Goltsblat BLP

## POST ACQUISITION ASPECTS OF INVESTING IN RUSSIA

- Post-acquisition aspects of investing in Russia**  
 Rainer Stawinoga, Partner, Russia Consulting 43
- Now that you've got the Russian financial statements, what are you going to do?  
 Can the Russian financial statements be useful to a foreign investor?**  
 Anton Kalanov, Head of International Accounting Department, Interexpertiza 46
- Product liability and aspects of consumer protection claims in Russian law**  
 Falk Tischendorf, Partner, Beiten Burkhardt 52

## REGIONAL ASPECTS OF INVESTING IN RUSSIA

- The post-crisis development of Southern Russia**  
 Vasily Vysokov, President and Chairman of the Board of Directors, Center-invest 56

## PECULIARITIES OF OPERATIONS OF FOREIGN SMALL AND MEDIUM BUSINESSES ON THE RUSSIAN MARKET

- SMEs investing in Russia: Things you should know**  
 Chetwynd R.F. Bowling, Managing Partner, Alinga Consulting 61

## INDUSTRY SPECIFIC ASPECTS OF INVESTING IN RUSSIA

- Transaction based finance products in Russia**  
 Joerg Bongartz, Chairman of the Board, Deutsche Bank 66
- Investing in Russian real estate: key issues to consider**  
 Olga Arkhangelskaya, Head of the Real Estate Group in the CIS, Ernst & Young (CIS) B.V. 68
- Russian real estate investment market: 2010 review**  
 Charles Boudet, Managing Director, Jones Lang LaSalle Russia & CIS 73
- Sustainable energy in Russia: a pipe dream or an opportunity?**  
 Jeroen Ketting, Director, Lighthouse Group 76
- Foreign investments in strategic sectors in Russia**  
 Alex Stoljarskij, Attorney, Beiten Burkhardt 78

## BUSINESS CASE: CREATING AN ENTERPRISE

- Investment opportunities for small/mid-size companies in Russia.  
 Case study: Specta Group's production investment in the Kostroma region**  
 Erik Helin, President, Specta Group AG 84

## PROSPECTS OF INVESTING FOR THE FUTURE

- Moscow as an international financial centre**  
 Alexey Plekhanov, Principal Economist, Office of the Chief Economist,  
 European Bank for Reconstruction and Development 89
- WTO, Russia's centerpiece for modernization**  
 Prof. Art Franczek, President, American Institute of Business and Economics 93

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## RUSSIA IS THE RIGHT PLACE FOR INVESTING

### Greenfield vs. Brownfield: What is the right strategy for investing within the Russian Federation?

Andre Scholz, Director General, Rödl & Partner



#### André Scholz

André Scholz is a Certified Auditor, Tax Consultant and Managing Partner at Rödl & Partner Russia/CIS.

Mr. Scholz has a track record of more than 10 years with Rödl & Partner, including 8 years in Russia.

His areas of expertise include the audit of financial statements, in accordance with German and international financial reporting standards, business appraisals and provision of advisory support to transactions. In particular, Mr. Scholz has a track record of providing successful consulting and advisory support to transactions in the chemical and automotive, wholesale and retail, food and furniture, logistics, trade in machinery and plastics-processing industries in Russia and the CIS countries.

In addition to speaking at various events, Mr. Scholz chairs the committee for taxes and accounting of the German-Russian Foreign Trade Chamber (Deutsch-Russische Außenhandelskammer or AHK) and is a member of the AHK Board.

He wrote a book on accounting practices in Russia, which appeared in Gabler-Verlag in 2008.

Language skills: German, Russian, English.

With the crisis now behind, investors are now coming to Russia to at the very least have a look at and access the country's market situation, in search of new investment opportunities. A lot of companies that were actively looking for projects and sites before the crisis are now here to continue with the search.

In comparison to a few of years ago, the current prices have gone down; this, of course, is for a variety of reasons. There is also proof that the local authorities are more serious in trying to successfully attract investors. Investors, on the other hand, are more careful now in choosing projects, sites and partners, than they were in boom-times.

This brings us back to the old question of how to structure an investment or an exploration within the Russian Federation. Please note that this article is

not a definite solution, but a guideline to making the right investment.

This article takes a look at the two possible strategies; although, it should also be borne in mind that both strategies may be successfully merged to give a worthwhile investment.

To begin with, I would like to define the terms Greenfield and Brownfield investment and exploration.

**Greenfield Investment** is the erection of a plant (service facility, dealership or shopping facility) on formerly untapped grounds.

**Greenfield Exploration** is when exploration companies look for resources other than the existing, known sources or areas where resources exist. Essentially, they look for resources in new, untapped areas.

Greenfield usually means always starting from scratch.

**Brownfield Investment** is the use of existing buildings, facilities or infrastructure setting up a venture (service facility, dealership or shopping facility). This does not necessarily mean that future use must be the same as in the past. For example, one of my clients converted a run-down plant for concrete tiles into a production facility for pickled vegetables.

But brownfield can also be the modernisation or expansion of a plant by altering or modifying the existing equipment or installing a completely new production line at the existing location by utilising already available facilities.

**Brownfield Exploration** is when exploration companies look for resources in areas surrounding known deposits and/or re-explore older mines/fields using new technologies, to see if greater reserves exist.

The following comparisons will focus mainly on investments and less on exploration.

The decision on the strategy (greenfield vs. brownfield) depends on quantitative and qualitative factors:

#### Quantitative factors

- Time limits;
- Investment cost;
- Profitability and financial viability.



## Qualitative factors

- External environment (especially legal facts);
- Technology;
- Design and engineering;
- Project management.

These factors have been further described below before the background of investment climate and environment in Russia.

## Gestation period

Aside from location, the main activities involved in a greenfield project are as follows:

- Site identification;
- Supply studies (materials, components, personnel, other resources);
- Environmental Impact Assessment and Environmental Management Plan;
- Technical concept;
- Financial closure;
- Project implementation;
- Stabilisation.

A brownfield project involves fewer activities:

- Supply studies (materials, components, personnel, other resources), but only in case of changes in terms of the use of facilities (expansion of capacity, other products etc.);
- Environmental Impact Assessment and Environmental Management Plan;
- Technical concept;
- Financial closure;
- Project implementation;
- Stabilisation.

As a result, the gestation period in a brownfield project is usually shorter than in a greenfield investment.

With my experience with investments in the Russian Federation, I can tell that they usually consume more time than budgeted and require tighter control.

Many investors decided to go for greenfield after vast experiences of failed joint-ventures and lack of good infrastructure in the 1990s and in the very beginning of this century.

Due to the growing burden of registration and other bureaucratic problems, many investors came back to brownfield and joint-ventures in pre-crisis time. We have seen a lot of investment projects, where the Russian partner provided his brownfield site and the foreign investor came up with the technology and financing.

In terms of flexibility with regard to location and other factors, brownfield is often preferable in Russia, as it results in a considerable economy of invested resources due to a shorter implementation time.

Site identification is quite important in this regard. Investors should focus on this and weigh their options. There are differences on the regional level with regard to support offered by the local administration. This can range from no support in some regions with great investment potential, to full support, including direct help with the paperwork or even site-supply on the part of the local authorities.

Russia's legal environment is such that it necessitates the possession of a considerable number of permits prior to the ability to make a valid investment. Although the processes and procedures required to obtain these permits are quite burdensome and time consuming, their absence can lead to an adverse outcome for the investor.

The Russian Federation is perceived by some as highly bureaucratic and this sometimes even affects international rankings on investment climate potential. A building project in Moscow involves various stages of permits and a construction permit may require the consent and signatures of as many as 20 or more different departments. Going through such a process step-by-step means that the design approval must be gotten prior to applying for a construction permit. On completion of the construction project, one must receive a certificate of compliance with the approved design and the construction permit, from the state. If the building in question is a plant, then a production permit must be obtained following the state issued approval/certificate of compliance.

In comparison to similar projects carried out in the past, one can not help but notice a considerable increase in the time taken to complete a construction project; now, the successful completion of a new production facility. A similar project in Western Europe would usually last for one and a half or two years. Many try to cut edges as no investor is willing to finance a project like this and take all the risks for such a long period of time. Typical examples are constructions without proper permits and the commencement of production activities without final approval.

This is definitively not standard, but common practice. Investors should be aware of the risks involved and decide for themselves.

Much emphasis is placed on environmental issues. The Russian legislation is tough in this regard and investors should note that this issue is closely monitored during the approval process and afterwards.

There is again an easier way, usually, for brownfield projects, provided that already existing permits can be used. A partnership with a Russian company is often used as a means of avoiding certain, not entirely mandatory inspections.

The decision to invest in a brownfield project may also imply less paper-work; the modernisation of an existing plant may not require the need to obtain a standard set of permits. However, the situation in every project varies and a decrease in the number of permits required may not be the order of the day in brownfield projects that require an increase in capacity or the use of an existing brownfield for a new type of production.

It usually helps a lot to cut red tape, while existing rights, licenses and contracts can be used; thereby, leading to a shorter and smoother gestation period.

“Time is money”, and this is especially so in the case of the next factor.

## Investment cost

This factor needs special attention in Russia as the investment costs are usually higher due to customs, higher transport costs, climate conditions, and red tape.

We have seen increases by up to 200% and more in comparison with Western Europe.

There are of course exceptions made, for example, for certain types of equipment usually called “high tech”; this is because the government strongly promotes development in the area of science and technology, which includes giving incentives to producers of goods not yet being manufactured within the country.

The Russian Federation is definitely not one of the cheaper alternatives in terms of existence; hence, as opposed to other Middle or Eastern European countries, one can not talk of low cost labour. Production in Russia is usually meant to cater to the local market and in some cases, the CIS countries. However, as is always the case with brownfield investment regardless of country, the one universal advantage is the lower cost of investment. This includes a decrease in the core investment cost as well as the cost of consultancy and paperwork.

At a given location, there is usually water, gas and electricity available, which makes up for a huge chunk of costs, in some cases, even in a greenfield investment. Though prone to occasional shortages or undersupplies, the Russian Federation is an energy-rich country. As a rule of thumb, the permit for the supply of 1 MW electricity – and only the permit, no infrastructure – may cost up to 1,000,000 US\$ within the Moscow Region. Some investors may deem it less expensive to build their own power stations; though in some cases, the local authorities may include the need to do so in the criteria for obtaining a construction or production permit.

Well known are obligations to built power stations or power lines, transformation stations, railway links or simply infrastructure within the community, for example, roads, bridges or even kindergartens.

All this adds to the investment cost and in some instances, plays a notable role with regard to taxation. On the one hand, there is the obligation levied by the permitting authority and on the other hand is the local tax authority, which may question the inclusion of these costs into the tax-base in form of depreciation.

In a brownfield project, these supplies should be available fully or at least partly, making the total investment lower.

Another kind of cost that should be considered is financing cost. This must be included in the overall investment budget and investors should be aware that local financing might be more expensive due to higher interests. The Russian tax code provides also for limits like thin-capitalisation-rules and caps on interest rates, which can increase the cost of financing by making some ways disadvantageous from the tax point of view. As tax authorities aren't keen on paying back input-VAT quickly, investors should plan for a longer period and/or a higher amount of financing. Bearing all this in mind, one begins to see that perhaps there, is to a greater extent, more sense in making a brownfield investment.

But as sites are in under-supply and even the existing ones may be lacking infrastructure, one may have no other choice than to opt for a greenfield investment.

The gestation period and investment cost have a direct influence on the profitability. The situations described above explain why profits are sometimes smaller or achieved in the Russian Federation later than in similar projects in other countries.

## Control and project management

Coming back to the issue of control, there is often a need for more outside control from the investor's staff. This increases the costs of the project; this is the case for both greenfield and brownfield investments. Investors should plan for permanent oversight on the investment site and send experienced staff or employ service providers, with a track-record of similar, successfully completed projects within the Russian Federation. The investor should also focus on project management as at the moment, there is a general lack of experience in this field within the Russian Federation. Currently, only a small amount of local employees have experience in project management. Due to shorter gestation peri-

ods the costs are usually lower for brownfield projects as well in this regard.

On the other hand, the issue of control is always easier and more adequately addressed within Greenfield projects. Greenfields can use the blueprints of former projects and as a result, the investor's staff are often able to implement this with less outside help. A greenfield is less likely to be a joint venture; therefore, the need for co-operation with a Russian partner is less likely. Co-operation is often difficult. Problems start with cultural differences and may even involve goals, on the part of the Russian partners, that may interfere with realising the aim of the project. In general, project management for the integration of new technology and machinery into existing premises and space is more demanding. Bearing this in mind, a greenfield project might be easier to manage in this regard.

## Summary

There is no easy way to decide which of the investments – greenfield or brownfield – is more advantageous for foreign companies in the Russian Federation.

Brownfield projects usually provide for shorter period of implementation and lower costs. Greenfields are often easier from the technological point of view. The investor has better opportunities to implement his own design; usually, engineering comes easier as there are no limits like old infrastructure or given spaces. Therefore, project management in a greenfield project is often easier in comparison to brownfield investment.

In all cases, the investor should make use of specialists for construction, environmental, legal and tax issues. The Russian set of rules for investment projects is bigger and more complicated than the majority of investors may think.

Whatever the decision, the investor must be aware of longer projects and higher costs within the Russian Federation in comparison with similar projects in western countries.

Nevertheless, there are a lot of profitable investments and investors are keen on putting money into such projects in the Russian Federation. In the long run, there is a big chance for higher yields. I wish all investors a good luck and a successful implementation of their projects, be they related to greenfield or brownfield investment.



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## Regulation of foreign investments into the Russian economic entities of strategic importance

Igor Artemiev, Head of the Federal Antimonopoly Service of Russia



**Mr. Igor Artemiev**

Head of the Federal Antimonopoly Service of Russia

Mr. Igor Artemiev was born on November 27<sup>th</sup>, 1961, in Leningrad. He graduated from the Leningrad State University, Faculty of Biology. Afterwards, he obtained his Masters from

the Faculty of Law of the St. Petersburg State University. Author of 43 articles and patents, he is also the author of 6 budget and economy monographs. He also holds a Ph.D.

From 1989, Mr. Artemiev took an active part in politics in Leningrad, which later became St. Petersburg. He was elected as a deputy to the Leningrad Council and later to the Legislative Assembly.

From 1992 to 1994, he was Head of the Commission for Ecology and Communal Economy of the Leningrad Council. From 1994 to 1996, Mr. Artemiev was Chairman of the Commission for the Municipal Economy and Chairman of the Budget Committee of St. Petersburg Legislative Assembly. From 1996 to 1999, he was the Vice-Governor of St. Petersburg and Chairman of the Finance Committee of the City Administration. From 1999 to 2004, he was Head of the Economic and Political Research Fund "EPICenter – St. Petersburg", where he annually presided over the Alternative Budget of the Russian Federation. Mr. Artemiev is also the draftsman of the "Concession Agreement Statute", "United Social Tax Statute", "Derivative Financial Implements Statute", "Statute of Reductive Taxation System for Subjects of Small Entrepreneurship", a cluster of Family Business Laws, Amendments to the Criminal Code, the Criminal Procedural Code and the Civil Procedural Code of the Russian Federation.

Since December 1999, he has been a Member of the State Duma of the Russian Federation. He has held positions of Vice Chairman of the "YABLOKO" faction and Vice Chairman of the Committee for Credit Organisations and Financial Markets.

Since the 10<sup>th</sup> of March, 2004, Mr. Artemiev has been the Head of the Federal Antimonopoly Service of the Russian Federation. He was appointed based on directive № 329-p, of Prime Minister Mikhail Fradkov dated 3<sup>rd</sup> of March, 2004.

In order to protect their national interests, most of the countries have introduced special legislation to regulate foreign investments in the industries, which are important to ensure national defense and state security. Conventionally, such industries are fuel and energy, telecommunications, hydrometeorology, aviation security, weapon manufacture. Enterprises of these industries, which are of strategic importance to any country, always draw attention of foreign investors and, at the same time, remain under the special control of the state.

In the Russian Federation, the necessity to adopt a new federal law to stipulate procedures for the supervision of foreign investments in strategic industries was under discussion for a long time, as soon as understandable and clear "rules of game" were required to raise investments in these spheres. These discussions resulted in the adoption of the Federal Law "*Procedures for Foreign Investments in the Economic Entities of Strategic Importance for National Defense and State Security*" (hereinafter: Law No. 57-FZ), dated 29<sup>th</sup> of April, 2008, which formed the regulatory basis in this sphere. The Law superseded previous isolated industrial-specific requirements and restrictions imposed for foreign investors in relation to investing in strategic industries. Clear decision-making procedures were introduced.

The Law defines types of activities, which are of strategic importance to national defense and state security. These are the industries directly related to defense and state security (different types of activities in the sphere of nuclear power engineering; development, manufacturing and sales of weapons and military hardware; space activities etc.), as well as the industries that affect state security in an indirect way (for instance, printing, if the economic entity in question can offer print runs above 200 million (mln) sheets monthly; editorial offices and/or publishers of periodicals with print runs of at least one million copies etc.)

According to the Law, any deal, which places a strategic economic entity under the control of a foreign investor, must be approved in advance, that is, application shall be filed to the authorised body: the Federal Antimonopoly Service. The Russian Federal Antimonopoly Service shall, within a rather narrow time frame (less than one month), carry out preliminary investigation of the submitted application and determine whether the deal is subject to consid-

eration by the Governmental Commission. For the deals that require preliminary approval, such resolutions are adopted by the Governmental Commission headed by the Chairman of the Government of the Russian Federation.

The list of deals that are subject to preliminary approval is specified in the Law No. 57-FZ. The specificity of the Russian regulatory model for foreign investments in strategic industries is a more stringent criteria for the supervision of subsurface resources management as compared to other strategic spheres.

In the event of a purchase of 5% or more, of shares or equity interests in strategic business companies, foreign investors are obliged to notify (inform) the Russian Federal Antimonopoly Service in the manner stipulated in the executive order of the Russian Government No. 795 – “*On the Approval of the Rules for Information Disclosure by a Foreign Investor or a Group of Persons Comprising a Foreign Investor Concerning Deals with Shares (Equity Interests) in Charter Capitals of Economic Entities of Strategic Importance for National Defense and State Security*”, dated 27<sup>th</sup> of October, 2008.

According to Law No. 57-FZ, in mid-2008, the Russian Federal Antimonopoly Service promptly developed and approved a sample form of a business-plan for a strategic business company, which must be submitted by a foreign investor according to Law No. 57-FZ, and a model form of Agreement to secure obligations of a foreign investor or a group of persons with respect to foreign investment in strategic business companies. These documents are available on the official web-site of the Russian Federal Antimonopoly Service ([www.fas.gov.ru](http://www.fas.gov.ru)).

It should be noted that Law No. 57-FZ is not the sole legislative act in the area of foreign investment regulation. Other important normative legal acts, which form the legal framework of regulation in this sphere are the Federal Law “*On Foreign Investments in the Russian Federation*” (hereinafter: Law No. 160-FZ), dated 9<sup>th</sup> of July, 1999, which provides for a “wide” definition of a foreign investor, as well as the Federal Law “*On Protection of Competition*” (hereinafter: Law No. 135-FZ), dated 7<sup>th</sup> of June, 2006, which gives definitions of certain terminologies used in Law No. 57-FZ, including “group of persons”, “coordinated activities”, etc.

Moreover, Law No. 135-FZ stipulates that, in cases where upon consideration of the application submitted according to the Law No. 135-FZ, it is established that the deal in question is subject to preliminary approval according to Law No. 57-FZ, the Russian Federal Antimonopoly Service is obliged to

pass a resolution with regard to the extension of the time allocated for consideration, until the approval of such a deal is in accordance with Law No. 57-FZ. In cases where the Governmental Commission for the control of foreign investments in the Russian Federation refuses to approve the deal in question according to Law No. 57-FZ, this shall serve as a justification to refuse the application under Law No. 135-FZ. This provision is of considerable importance to the overall procedure for the approval of deals concerning strategic economic entities, as well as for the approval of deals related to economic concentration.

Law No. 57-FZ has been in effect for two and a half years. Since it entered into force, the Russian Federal Antimonopoly Service has considered 189 applications (for 66 of these applications, resolutions were passed by the Governmental Commission), over 400 notifications and about 250 enquiries and petitions from foreign investors concerning the Law’s practical application.

Moreover, the Federal Antimonopoly Service has not avoided discussing possible practical applications of the Law currently being developed, in public. The Federal Antimonopoly Service has held over 80 meetings with foreign investors and participated in 50 seminars and round tables dedicated to the discussion of foreign investment in strategic economic entities. All these activities have contributed to developing the efficiency of the Law’s practical application, as well as a better understanding of the Law by foreign investors.

Among the applicants that submitted applications and notifications there were 2 international organizations, 24 entities controlled by foreign states or international organisations, as well as more than 130 private foreign companies from 30 countries.

During the second half of 2009, typical problems with the applications submitted by foreign investors in manner stipulated by the Law No. 57-FZ became obvious. In order to eliminate them, the Russian Federal Antimonopoly Service, together with other federal authorities, has developed a draft – “*Rules for the preliminary approval of deals and control of foreign investors or a group of persons comprising a foreign investor over economic entities of strategic importance to national defense and state security*”, approved by the Resolution of the Government of the Russian Federation No. 838, dated 17<sup>th</sup> of October, 2009.

A special remark shall be made on the strategically important activities to improve legislation in the sphere of governmental control over foreign investment in strategic industries, because the na-

tional investment climate in general depends upon the clarity of rules and requirements of Russia in this sphere.

Amendments to Law No. 57-FZ were developed and submitted for consideration to the Russian Government, with the aim of eliminating certain issues with regard to practical application and improving the regulation for foreign investment in strategic economic entities.

In conclusion, we wish to give several practical recommendations to foreign investors who would like to purchase shares or equity interests in charter capitals of strategic business companies.

In the course considering submitted applications, the Russian Federal Antimonopoly Service often encounters incomplete document sets submitted by the applicants. In certain cases, there is no information concerning the parties that have indirect control over the applicant, or no information about agreements or coordinated activities of the applicant, which can substantially affect activities of a strategic business company. As a result, the Russian Federal Antimonopoly Service is forced to forward enquiries to the applicants to obtain the necessary information, which in turn, results in a longer consideration period of the applications.

Thus, foreign investors should compile the document pack submitted with the application on the basis of the Law No. 57-FZ, as well as the Resolution No. 838 of the Russian Government, dated 17<sup>th</sup> of October, 2009, which governs the approval of those aspects of deals concerning strategic economic entities which are not addressed in the Law No. 57-FZ.

Foreign investors often pay insufficient attention to the business-plans of strategic economic entities, submitted alongside the applications. Foreign investors should avoid a formal approach to the development of business-plans, as their implementation can become a binding obligation imposed by the Governmental Commission on the applicant as a pre-requisite to approve the deal.

Foreign investors should bear in mind that in cases where the deal in question is subject to preliminary approval according to the Law No. 135-FZ and Law No. 57-FZ, they should submit their applications with regard to these Laws as 2 separate sets of documents, in the established manner: the first set will be viewed on the basis of the competition practices as stipulated by Law No. 135-FZ, and other will be submitted for consideration by the Governmental Commission in the manner specified in Law No. 57-FZ. As mentioned above, until the Governmental Commission has made a decision, all processes involving the application's consideration

by the Russian Federal Antimonopoly Service, with regard to economic concentration shall be put on hold. Concurrently, additional information shall be gathered, if required, for the evaluation of the relevant product market, etc. Once the Governmental Commission has made a decision, the Federal Antimonopoly Service receives all relevant protocol; subsequently, approval in terms of anti-monopoly legislation shall be issued in soonest time possible.

In cases where the foreign investor is uncertain about the necessity of having the deal approved within the scope of Law No. 57-FZ, for instance, where the control of the foreign investor over a strategic business company is not obvious, Law No. 57-FZ specifies a clarification procedure. Particularly, according to this Law, foreign investors are entitled to forward to the Russian Antimonopoly Service enquiries on the necessity to approve the planned deal, in line with the documents specified in the Law.

The Russian Federal Antimonopoly Service, upon the appropriate evaluation, shall respond within one month with regard to the necessity of obtaining an approval for the deal in question from the Governmental Commission, and inform the Governmental Commission of such enquiry and the followed response.

However, it should be noted that the list of documents required to make an official enquiry is almost identical to the one required to submit an application. Moreover, such consideration requires extra time. Thus, in order to cut the time required to approve the deal, the foreign investor can submit an application and, if it is determined that the planned deal does not result in the establishment of control over a strategic economic entity, the Russian Federal Antimonopoly Service will, by obligation, return the application 14 days upon its receipt, since the deal requires no preliminary approval.

In my opinion, the supervisory regime for foreign investments in strategic industries in the Russian Federation is rather liberal. Since Law No. 57-FZ came into effect only two of the 189 applications filed for consideration were refused.



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## BEFORE YOU START

### Investing in Russia: Can you afford not to?

Mark Okes-Voysey, Managing Partner, PricewaterhouseCoopers



#### Mark Okes-Voysey

Mark Okes-Voysey, a UK national, is the Managing Partner of PricewaterhouseCoopers Advisory business in Central and Eastern Europe. Mark has been resident in Russia since 1997 and has broad international experience gained in

London, New York, Madrid, Mexico and Moscow.

His personal specialism is in Mergers and Acquisitions in which he has advised both private equity and strategic investors on deals ranging from the low millions of dollars to billion dollar plus.

The move by Pepsi to acquire Wimm-Bill-Dann for almost \$4 bn has been welcomed by its investors. Those institutional shareholders in Pepsi recognise the value to be generated by businesses with strength in key growth markets, such as Russia.

The view from Moscow has rarely looked so robust and attractive as Russia's political leadership demonstrates its commitment to promoting its business agenda. The visible level of state backed activity to raise Moscow's profile as an international financial centre of the future and the specific steps being taken to promote innovation in the economy, for example, the now famous Skolkovo project, are good examples of the refreshing approach to driving a more robust business environment. Early days, but positive developments nevertheless. To my mind the direct benefits of these initiatives will no doubt be felt in the coming years but, in the shorter term, they are positive indicators of the openness of Russia to new business.

Sceptics will no doubt say that these initiatives will never happen. My response is always the same. Ten years ago who would have thought that Russia would be winning over the IOC and FIFA to host the Winter Olympics in Sochi in 2014 and then the Soccer World Cup just four years later? Both events will ensure the global spotlight is on Russia and will galvanise moves to improve the infrastructure within this growth market. A determined Russia has shown time and again it can succeed when it puts its mind to it.

For those of us who have been working in Russia since the 1990s and before, the journey to today has

been nothing short of remarkable. It was not that long ago, a little over a decade, that the currency collapsed and fears persisted over the nation's ability to prosper. At many times during the last 14 years I have felt that we were not always moving forward at the pace you would expect from one of the BRIC's. But when you look back the progress has been remarkable even though this has been far from a linear progression. Personally I have never been so excited about the future opportunities in this country.

#### The appetite to invest is there...

The quest for growth is driving the agenda for business leaders across the globe and Russia represents an obvious and attractive place to make their mark. The 2011 Global CEO Survey – produced by PwC in partnership with the World Economic Forum – and released at Davos two weeks ago was titled Growth reimagined. It is the latest piece of evidence demonstrating how important markets such as Russia are to the global cadre of CEOs tasked with generating growth in these uncertain times.

The report – available from our web-site – features interviews with numerous CEOs who run businesses across the world talking optimistically about how they can grow their top and bottom lines in 2011.

During the financial crisis the emphasis for CEOs was how they could cut costs to ensure survival. Today the economic climate has changed for the better and this is evidenced by the reports' findings demonstrating the growing confidence levels of CEOs in seeking out opportunities for growth.

#### ...and the attractions of Russia become increasingly obvious

Growth reimagined emphasises how global CEO's are particularly focused on growing revenues in regions where the recovery is strong such as Germany but also where the promise of growth is stronger still. Russia has a big role in this growth fuelled by the strong growth in consumption and the development of its middle class as well as the strength of its human capital. The drivers of future growth and opportunity are clear:

Behind the headlines there are some astonishing figures that bring the opportunity to life. Perhaps

a little known fact but the state sponsored Special Economic Zones is a good example of the good news in Russia which is often not heard as loudly as some of the more negative soundbites (see below).

Meanwhile there has been a rapid increase in the financial clout of the regions throughout Russia. Received wisdom suggests they have historically lagged Moscow by at least five years but the gap is shortening with research suggesting demand is growing dramatically. As a result large retailers are rolling out ever greater numbers of stores in the regions.

Russia Inc has one of the strongest balance sheets in the world and despite its bad press, mainly because of administration and often, lack of clarity, it has a relatively attractive taxation system.

Yes I am bullish on Russia and after a lull during the crisis we are beginning to see a real upturn in the level of companies looking at M+A and other investment opportunities in Russia.

## The acquisition route

Without doubt the quickest route for entry into the Russian market...you get it all the good and the bad on day one. There are two issues here (1) the likely lack of viable targets in your sector (2) the cost of transforming the business regardless of how profitable it is today. From environmental practices to reporting systems to salary levels to cost of energy systems. The sustainable outlook may be very to the historical one. It's not only a question of valuation but also one of manageability ie, the possible acquirer will need to consider that even if the price is can you devote the right management time to get it right.

Since arriving in Russia I have been involved in over 50 M+A deals of all sizes. Some closed, many did not. Other articles in this publication will no doubt cover the due diligence process in more detail but one comment I would make is that the due diligence process is, generally speaking, becoming easier – although we see very notable exceptions to this all the time. Clearly each deal is very different but I have noticed a number of recurring themes in the ones that have not happened or happened and gone wrong:

- 1) The due diligence process has focused almost exclusively on history (financial results, tax ,legal etc) and only a lighter touch given to analysis of the projections implied in the valuation ie a lot of work done on the valuation but not enough on how you will achieve these from an operating perspective.
- 2) Inadequate consideration of the human resource components of the deal. In particular attention to the individuals from the buyer or target who will be running the business.

3) This may seem like a surprise, but on smaller deals where owner-managed businesses are being acquired a great deal of time often has to be spent on engaging at the emotional level. In my experience issues manifest themselves in different ways; (a) deals collapsing at the last minute even when “the price is right” because the owner gets cold feet about selling his or her creation – a real disappointment when you have spent 18 months on a deal believe me! (b) when deals do happen the previous owner and now manager becomes a blocker to changes wanted by the new shareholder. No simple answers. But do pay attention to this.

4) Over optimism on integration/ synergy realization planning I remain amazed at just how many business fail to effectively integrate the businesses they have just bought. Winning the deal is only a portion of the battle, as difficult as getting the deal done may feel it is only the beginning of creating any value. The single most important mistake I see time and again is the lack of connectivity between those doing the deal and the management team that will need to deliver the planned results. In the drive to get deals done improvements are often rationalised by the M+A team which operational people subsequently cannot deliver. My strong advice (a) get the management team that will be running the business to embrace (acceptance not enough!) the improvements planned and develop an operating plan to achieve these before you close the deal (b) be cautious with timelines; time and gain I see transformation timelines which are far more aggressive than achievable.

Why are more deals not happening? Well part of the reason at least is that differences in buyer-seller expectations on valuations, whilst having narrowed are still there.

## Alternative market entry approaches

Of course acquisitions are not the only route in and early on potential investors should consider the merits of going the greenfield, brownfield or joint venture route.

The greenfield/brownfield route:

The attraction of going greenfield is clearly that it gives the investor greater flexibility and control and do “things right” from the beginning. It presents an opportunity for an organisation to select their site, manufacturing and supply needs and position themselves with the best proximity to high quality infrastructure and labour. It is possible to secure regional investment incentives and tax benefits and as mentioned before there is a good govern-



ment initiative the “Special Economic Zones”. This exciting initiative has some notable success with a reported 238 companies having committed \$8 billion of investment. Many of the usual pitfalls of going Greenfield (obtaining permits and other regulatory aspects) can be significantly expedited by setting up in one of these zones.

Those looking to set up operations in the Russian market are well advised to consider this as an option. Where should you be considering? Well there are a number of options as shown in Box 1.

Going brownfield, that is modernizing existing sites is another option. Whilst having the advantage of an established physical and potentially labour infrastructure it has certain disadvantages. Notably, the fact that government incentives may be a lot harder to come by and legacy risks, particularly environmental, will be inherited.

## The joint venture route

Theoretically, this is an option. The complexities of effective joint venturing other than in industries where

this is standard *modus operandus* are well documented in many business analyses across the world. My experience leads to one simple piece of advice – avoid this route if you can. In addition to the usual complexities of any deal there will be many additional complexities particularly surrounding governance issues – the scope for disputes amongst the venturers is often simply too big. If you are going down this route do your homework as on any deal and, critically, make sure you have a strong basis for having zero doubts about how successfully you can sustain an effective business relationship with your partner.

## Conclusion

Russia offers great opportunities – many successful investors in Russia will testify to this. Do your homework up front, ensure strong relationships with all stakeholders including government and regulators and the potential rewards are great. I hope you enjoy the journey as much as I have enjoyed the last 14 years here. I am convinced the best is yet to come – can you afford not to be here?

### Box 1

Choosing your own Economic Zone – focus industry	
<p><b>Alabuga (Republic of Tatarstan)</b>  <b>Total zone area – 1 997 hectares:</b></p> <ul style="list-style-type: none"> <li>■ automotive</li> <li>■ construction materials</li> <li>■ chemical and petrochemical</li> <li>■ FMCG</li> </ul>	<p><b>Lipetsk Region</b>  <b>Total zone area – 1 027 hectares:</b></p> <ul style="list-style-type: none"> <li>■ electric and energy machinery construction</li> <li>■ chemical</li> <li>■ construction materials</li> <li>■ domestic appliances and trade equipment</li> </ul>
<p><b>Togliatti</b>  <b>Total zone area – 660 hectares:</b></p> <ul style="list-style-type: none"> <li>■ automotive</li> <li>■ transportation equipment</li> <li>■ machine tool building</li> <li>■ precision engineering</li> </ul>	<p><b>St. Petersburg</b>  <b>Total zone area – 129 hectares:</b></p> <ul style="list-style-type: none"> <li>■ instrument engineering</li> <li>■ medical technologies</li> <li>■ electronics</li> <li>■ information and communication technologies</li> <li>■ nanotechnologies</li> </ul>
<p><b>Zelenograd (Moscow)</b>  <b>Total zone area – 146.9 hectares:</b></p> <ul style="list-style-type: none"> <li>■ microelectronics and optoelectronics</li> <li>■ nanotechnologies</li> <li>■ bioengineering and biosensor technologies</li> <li>■ information technologies</li> </ul>	<p><b>Dubna (Moscow Region)</b>  <b>Total zone area – 187.7 hectares:</b></p> <ul style="list-style-type: none"> <li>■ nanotechnology</li> <li>■ biotechnology</li> <li>■ nuclear technologies</li> <li>■ information technologies</li> <li>■ electronics &amp; communication</li> </ul>
<p><b>Tomsk</b>  <b>Total zone area – 207 hectares:</b></p> <ul style="list-style-type: none"> <li>■ communication equipment</li> <li>■ medical technologies</li> <li>■ electronics &amp; instrument engineering</li> <li>■ information technologies</li> </ul>	<p><b>Sovetskaya Gavan port zone</b>  <b>Total zone area – 450 hectares:</b></p> <ul style="list-style-type: none"> <li>■ port operations</li> <li>■ transshipment services</li> <li>■ vessel maintenance, repair, overhaul and re-equipment</li> <li>■ processing of seafood</li> </ul>
<p><b>Ulyanovsk port zone</b>  <b>Total zone area – 640 hectares:</b></p> <ul style="list-style-type: none"> <li>■ aircraft maintenance, repair and overhaul</li> <li>■ aircraft re-equipment and conversion</li> <li>■ logistics</li> <li>■ dispatching</li> <li>■ aviation training (pilots)</li> <li>■ manufacturing</li> </ul>	<p><b>Murmansk port zone</b>  <b>Formed by decision of Russian government in October 2010:</b></p> <ul style="list-style-type: none"> <li>■ port operations</li> <li>■ transshipment services</li> <li>■ vessel maintenance, repair, overhaul and re-equipment</li> <li>■ processing of seafood</li> </ul>

## Addressing sustainability related risks in the emerging business environment

Valery Kucherov, Head of Performance & Assurance Services and Elena Amirkhanova, Head of Impact Assessment and Planning Services, ERM Eurasia



**Valery Kucherov**

Valery Kucherov is the Head of Performance & Assurance Services of ERM Eurasia and Principal Consultant/Project Manager in the Moscow office, with experience in managing and implementing Environmental, Health and Safety and

Social Management Systems (EHSS MS) projects and EHSS Due Diligence projects, in accordance with international and Russian requirements, as well as other complex assignments across different industries (oil & gas, manufacturing, power).

Mr Kucherov has recognised international experience in successfully implementing many EHSS projects for large multinational companies and international development agencies (USAID, EBRD, IFC).

As a Certified Trainer/Lead Auditor in Environmental Management Systems he has conducted relevant training courses for a large number of Russian and international companies.

Valery graduated from the Lomonosov Moscow State University (MSU) and prior to joining ERM he worked in the Ministry of Foreign Affairs of the Russian Federation and joint projects of the MSU and the Federal Agency of Atomic Energy in the field of management of radioactive waste.

Currently, Valery is a member of several international, professional and business associations, including the International Register of Certificated Auditors (IRCA) of the Chartered Quality Institute (UK).



**Elena Amirkhanova**

Elena Amirkhanova is the Head of Impact Assessment and Planning Services at ERM Eurasia and Principal Consultant/Project Manager in the Moscow office, with experience in managing and implementing environmental and social assess-

ments and stakeholder engagement procedures, as well as Environmental, Health and Safety and Social Due Diligence (EHSS DD) projects, in accordance with international and Russian requirements.

Elena managed and implemented projects for International Financial Institutions (EBRD, IFC, EIB etc.) and multinational companies in different industries (metals, mining, infrastructure etc.).

Elena graduated from the Lomonosov Moscow State University. Prior to joining ERM, she worked for UNDP, the Ministry of Natural Resources of the Russian Federation and Trans-Siberian Gold Management. Elena is a Social Systems Auditor/Lead Auditor in Social Accountability SA 8000; she has also successfully completed a training course on IFC/World Bank Environmental and Social Performance Standards executed by the IFC Department of Environment and Social Development in Moscow, Russia.

### Issue

In the new operating environment, all natural resources companies are more sensitive and vulnerable to major project delays stemming from non-technical sustainability risks – political uncertainties, environmental, social & security issues and associated stakeholder pressure.

One might be tempted into thinking that a sustainability (or so-called “above-ground”) risk doesn’t matter so much in the current environment. However, this is an inaccurate and dangerous view. Political risks, competition between Western and non-Western firms under different “rules”, stake-

holder pressures, and related social & environmental issues are not going away, particularly, in Russia.

In fact, indications are that sustainability risk is becoming an increasingly important factor in so-called “safe” countries as well, particularly now with the greater role governments are playing in economic affairs and the considerable influence these risks have on issues such as climate change and alternative energy. The competition between Western and non-Western companies (especially Russian ones) – creates additional complexities to the management of sustainability risks.

This article focuses on the nature of sustainability risks and their implications on significant industrial and extractive projects and provides recommendations on how to timely identify and manage them in the course of operating in the Russian emerging market environment.

## Challenges

Sustainability risks are not abating in spite of the current economic climate. On the contrary, not only does sustainability risk remain present in the natural resources sector, but current economic conditions will make all capital projects that have not been postponed (and their sponsors) more sensitive and vulnerable to delays caused by politics, community protests, stakeholder opposition, or related issues. A quick scan of recent events affecting the sector should make it clear that non-technical risks are still very present

Recent analysis of the delays associated with a sample of the world’s largest 190 extractive projects (as ranked by Goldman Sachs research) demonstrates (Fig.1) that most project delays are due to non-technical (sustainability) reasons (e.g. politics, social, stakeholder pressures), rather than commercial or technical ones.

Based on ERM’s experience, the main sources of sustainability risks are as follows:

- 1) Uncertain regulatory framework;
- 2) Incomplete understanding of non-technical risks and wrong approach to address sustainability issues;
- 3) Focus on compliance;
- 4) Inadequate targets;
- 5) Application of technical culture to non-technical risks;

- 6) Difference in competition between Western and domestic companies in emerging markets.

### Uncertain regulatory framework

The Russian Federation has a complex system of Environmental and Health and Safety (EHS) regulatory and approval processes that are constantly changing. Partly, this is caused by the fact that most of the EHS laws came into the force in the beginning and mid 1990s and do not reflect the current social, economic and political reality. The issue is being exacerbated by inconsequent and non-systematic changes accepted by the authorities in different periods of time, which cause certain contradictions within the existing laws and regulations and impede and complicate their interpretation and use.

### Incomplete understanding of non-technical risks and wrong approach to addressing sustainability issues

In ERM’s experience, the approaches many companies take to sustainability fail to recognise the nature and commercial impact of non-technical risks.

Because sustainability risks are driven by socio-political actors and conditions, they are very dynamic. Opinions and incentives of governments and other stakeholders can change quickly, as can the variables that affect risk environments. These risks are also interdependent – an environmental issue for instance, can quickly become a political

## Historically, many industrial companies have struggled with poor sustainability performance

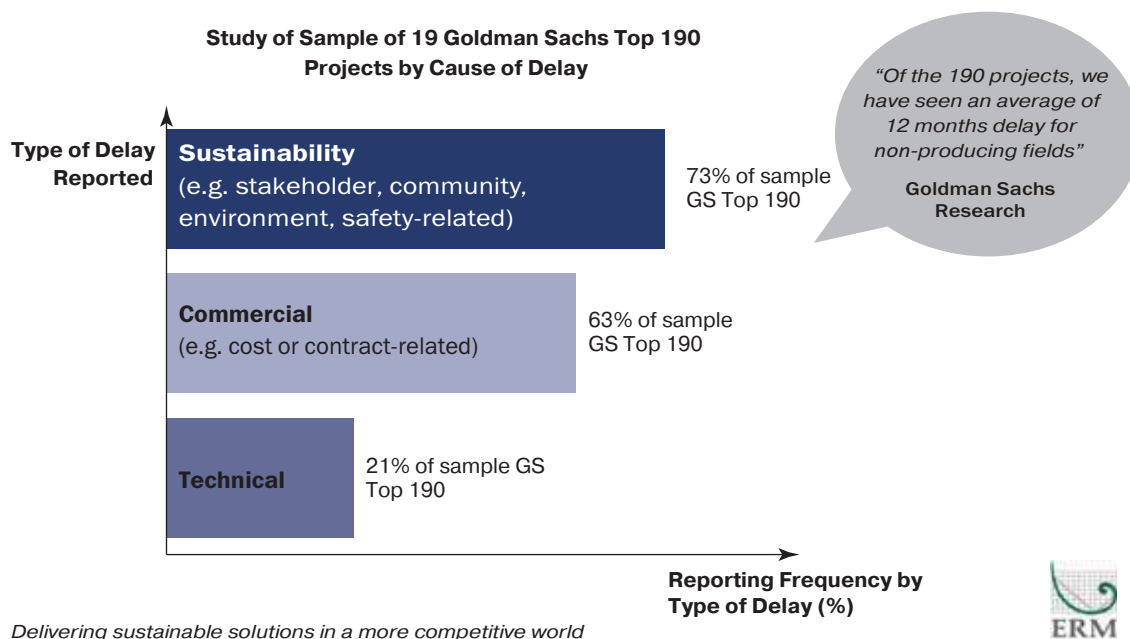


Fig. 1. Analysis of the delays associated with a sample of the world’s largest extractive projects (source: Goldman Sachs)



issue and vice versa. This also means that many above-ground risks cannot be neatly packaged to fit a particular, specialised internal function to address. Most organisations possess particular functions to “own” types of above-ground risks. These include HSE, External Affairs, Security, Strategy, Risk and CSR. Many of these functions use specific processes to deal with various types of above-ground risk. However, the dynamism and volatility of above-ground risk means that many of these risks are necessarily cross-functional. It is often not possible for one function alone to deal with a particular risk nor is it possible to neatly codify a particular process that will cleanly deal with these types of risks.

Many of the resources dedicated to dealing with above-ground risk are aimed primarily at meeting regulatory requirements, obtaining permits or complying with specific legislation. They are often far removed from the activities and concerns of the core business.

### **Focus on compliance**

We find that most activities in this space are predominantly focused on securing permits, completing Corporate Sustainability Reports, or managing internal and external audits. They are rarely focused on managing performance targets – e.g. minimising project delays or capex variance, adding value to project pipelines, etc.

### **Inadequate targets**

We often find that the targets of core business functions rarely include tangible and measurable targets around sustainability performance. Targets in these areas remain fuzzy (e.g. “engage stakeholders”) rather than measurable and time-bound (e.g. “avoid project delays due to community protests during construction phase”).

### **Application of technical culture to non-technical risks**

We find that a performance culture based on technical prowess in many companies often leads to two sub-optimal outcomes on sustainability risks. First, many companies downplay the importance of sustainability risks to their operations because of a technical or “below-ground” bias on projects. Second, we find many instances of technical solutions applied to non-technical problems – this usually means an emphasis on processes and systems rather than on accountabilities, incentives, strategy and leadership.

### **Difference in competition between Western and non-Western companies**

The world’s largest non-Western extractive companies do not all compete on the same terms, or with the same objectives as most large Western companies. This is not to say that non-Western firms do not obey the laws of host countries on these matters – evidence suggests the contrary. What it does mean is that many non-Western companies do not adhere to the same practices as a Western firm. Often, one will not see a Russian company, for instance, typically engaging in the same practices as a Western firm on stakeholder engagement, social investment, local content, managing social or environmental impacts beyond what is required by local law. These things are not yet an indispensable part of the business model of Russian companies. One reason for this is a lack of experience in these issues. A second reason, however, is that in many cases, non-Western companies neither face the same levels of stakeholder pressure from NGOs, institutional investors or regulations in their home states nor do they see a commercial imperative around these issues.

### **Implications**

Companies have been delaying or abandoning development projects and acquisitions they were aggressively pursuing just a few months ago.

During a recent client engagement ERM worked with people across the business (senior business leaders, finance executives, project directors, etc) to estimate the scale of the financial impact of delays caused by sustainability risk. They helped shape a working hypothesis that sustainability issues are becoming serious challenges to business success and this was the first time anybody had really tried to get to grips with the cost of poor performance. Results of the survey (Fig. 2) confirmed that sustainability risks can cost billions of dollars, which has been also proved by the fact that in the recent year the world has seen a number of events (e.g. the situation in the Gulf of Mexico) which have tremendously affected the reputation of international companies and resulted in a significant drop of their stock value.

### **Recommendations**

#### **1) Understand and assess sustainability risks more realistically**

Companies ought to spend more time understanding the nature of and their exposure to sustainability risks and subsequently, integrating non-technical considerations into production forecasts, project

## Sustainability related risks can cost billions of dollars

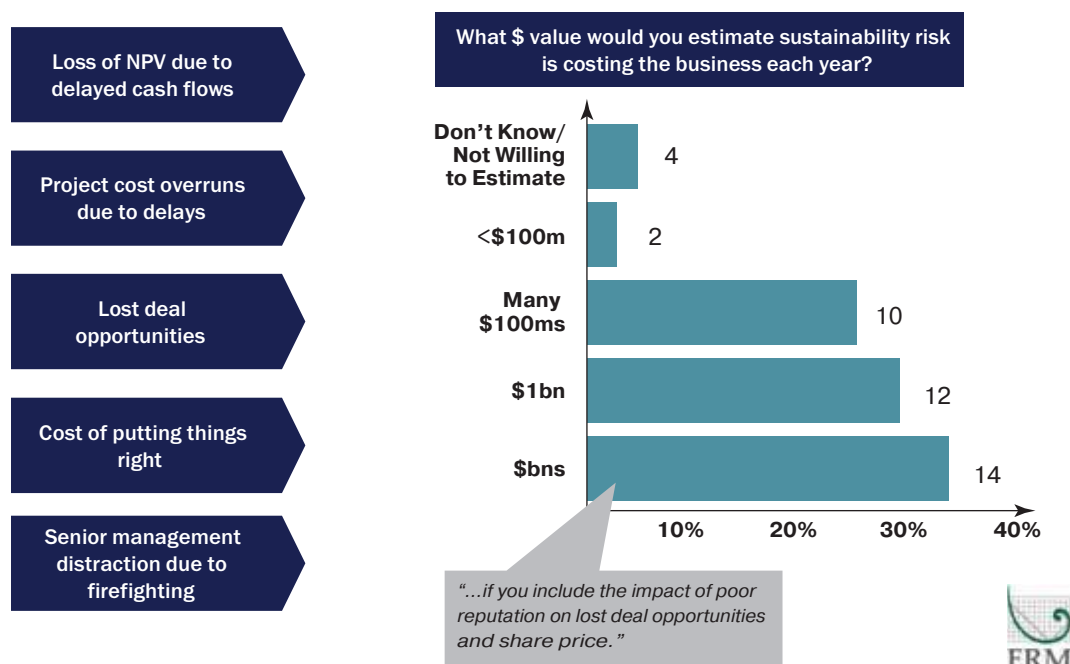


Fig. 2. Results of a recent companies executives survey on their vision of the cost of poor sustainability performance (source: ERM)

timelines and capital expenditure. This should involve realistic quantification of the commercial impacts of non-technical risks and the process should begin early in the project cycle.

### 2) Emphasise practical support

Companies are going to need to deploy the resources they have on above-ground issues in an intelligent manner. We believe that this will mean providing practical support to projects on-the-ground, minimising corporate HQ-led initiatives and reducing activities that provide little value.

### 3) Integrate project teams

Companies need to integrate project teams so that technical, operational, commercial and EHS risk specialists are all involved in planning and decision-making.

### 4) Align incentives

Companies need to align incentives on sustainability, technical and commercial performance on key capital projects with a focus on delivering realistic commercial targets. Often, incentives are designed without this type of integration and the result is that project delivery suffers.

### 5) Make accountabilities clear

Companies will need to assign clear and measurable accountability for various aspects of sustainability performance.

### 6) Provide strong leadership

Company leadership will need to have a high degree of visibility of sustainability performance and involve themselves in driving the shift from a compliance to performance-based approach.

### 7) Measure results using core business metrics

Companies will need to move away from only measuring their sustainability performance using metrics removed from the core business. Value on sustainability management will need to be assessed using the same type of metrics used in the rest of the business – project delivery, budgets, share price performance, etc.

## Investing in Russia? What to know about tax and legal before you go

Alina Lavrentieva, Partner, PricewaterhouseCoopers



**Alina Lavrentieva**

Alina Lavrentieva is a Partner at PricewaterhouseCoopers Russia B.V. Alina holds a Ph.D. in Economics and is a Certified Auditor. Alina is one of the leading specialists within PricewaterhouseCoopers Russia B.V. providing consul-

tancy services to major multinational and Russian companies; she has extensive experience and knowledge in dealing with corporate tax, accounting and related issues.

Prior to PricewaterhouseCoopers Russia B.V. Alina was the Finance Manager of a large multinational company, as well as was working for a professional firm of advisors. She is the chairperson of the Taxation Committee of the Association of European Businesses in the Russian Federation.

Alina is a regular speaker at conferences on Russian tax and related issues, both in Russia and overseas and has represented organisations such as the Association of European Businesses in the Russian Federation, Adam Smith Institute, Association of International Pharmaceutical Manufacturers in Russia and the Russian Union of Industrialists and Entrepreneurs at several conferences.

Russia is increasingly seen as offering a stable investment climate for global investors. Over the past few years, Russia's share of foreign direct investment (FDI) inflows has grown markedly. And, even as Russia-bound FDI has slowed somewhat in the lingering wake of the global financial crisis, the general trend remains positive, driven by a growing domestic market, highly skilled human capital, abundant natural resources and political stability. Despite contracting post crisis, the Russian economy resumed moderate growth as it moved into 2010. This gradual recovery has been driven by a combination of rising oil and commodity prices, tight monetary policy and government support for core enterprises, spelling new opportunities for foreign investors in 2011 and beyond.

If you are considering doing business or investing in Russia, this look at some key tax and legal issues should answer many of your questions and help you make an informed investment decision.

### How should I organise my business?

Starting a business in Russia is primarily governed by the Russian Civil Code (Chapter 1) and a number of specific laws and regulations, which outline how legal entities are incorporated, including incorporation documents, name, location, governance and official registration. Also, it defines what constitutes a branch or a representative office and regulates corporate reorganisation and liquidation. Foreign investors in Russia can choose from a number of different forms of business representation, ranging from Russian legal entities (RLE) to representative offices and branches of foreign legal entities (FLE). RLEs take various forms, including joint-stock companies, limited liability companies (LLCs) and partnerships.

Representative offices of FLEs are strictly limited to conducting liaison and support functions only. In contrast, branches of FLEs are free to perform full-scale business activity in Russia. Some first-time foreign investors initially opt for a branch because they can engage in any kind of commercial activity (which does not specifically require establishing an RLE, e.g., banking, insurance etc.), are easier to establish and have less onerous reporting requirements than RLEs.

But, in some cases, an RLE may best meet the needs of certain types of investments, including joint ventures and manufacturing projects because RLEs enjoy certain advantages in licensing, customs and participating in privatisation tenders. A company may be established either by incorporating a new company or reorganising an existing entity through consolidation, merger, split-up, spin-off or a change in legal form. A company is considered to be established from the date of its official state registration.

A quick guide to the differences between branch and subsidiary may help investors to take the proper decisions.

A foreign legal entity doesn't have to pay Russian profits tax if it provides funds and/or assets to its Russian branch. The situation is different for subsidiaries. Contributions to a subsidiary are only tax exempt if they are capital contributions or represent the provision of funds/assets to a subsidiary in which the FLE holds more than a 50% stake. An FLE can repatriate cash from its Russian branch to its head office without restriction after corporate profits tax has been paid at the permanent estab-



lishment level. In contrast, repatriation of cash by a subsidiary is subject to Russian withholding tax, unless, it is exempt or taxed at a reduced rate under a Double Tax Treaty (DTT).

The main advantage of doing business through a subsidiary with several subdivisions is that you have the option of consolidating profits and losses for tax purposes. This kind of consolidation is not allowed for an FLE's Russian branches, unless, their operations constitute a unified technological process and the Russian Ministry of Finance (MinFin) has granted special approval. In practice, however, we are not aware of any cases where the MinFin has actually granted such approval.

Importantly, VAT consolidation is allowed for both branches and subsidiaries of a foreign company. Branches with permanent establishment status in Russia are normally entitled to deduct general and administrative expenses incurred by the head office under a relevant DTT. Here, we find another key difference – a subsidiary cannot deduct expenses incurred by the parent company.

It's important to note that whether or not a foreign company creates a permanent establishment (PE) in Russia depends on the nature and scope of its activities and not its legal form. FLEs pay tax on profits attributable to a PE, which is broadly defined as "a branch, division, office, bureau, agency, or any other place through which a foreign legal entity regularly carries out its business activities in Russia." A tax relief may still be possible, as some of Russia's bilateral DTTs may define a PE differently. Doing business through an agent may also create a taxable PE in Russia.

Overall, as of today, the following types of commercial (for-profit) legal entities can be incorporated in Russia:

- Full partnerships;
- Limited partnerships (so-called "kommandit" partnerships);
- Limited liability companies (LLC, or OOO in Russian);
- Additional liability companies;
- Production cooperatives;
- Joint-stock companies (JSC), both open and closed; and
- Unitary enterprises (state-owned legal entities not open to foreign investors).

Of these, only the JSC resembles a corporation; but limited partnerships, as well as limited and additional liability companies also limit the liabilities of investors, as described below.

Under the Civil Code, a JSC's capital is divided into a definite number of shares. As a general rule

(which may have certain exceptions in bankruptcy and certain other procedures), JSC's participants (the shareholders) are not liable for the company's obligations and accept the risk of business losses commensurate to their respective stakes. They can have a shareholders' agreement to regulate their rights.

Russian law states that only joint-stock companies may issue shares, which are deemed securities and must be registered. The law also defines two kinds of JSC: "open" (OAO in Russian) and "closed" (ZAO in Russian), which are broadly equivalent to public and private companies. Open joint-stock companies must disclose certain financial data and other information annually. A JSC's share capital is composed of the nominal number of shares acquired by the shareholders. The minimum "charter" (share) capital for both open and closed JSCs is equal to 1,000 times and 100 times, respectively, of Russia's minimum monthly wage.<sup>1</sup>

Under the Civil Code, a limited liability company (LLC, or OOO in Russian) can be established by one or several persons whose charter capital is divided into shares according to the incorporation documents. In an LLC, the liability of each participant is limited to the value of his or her contribution (unless certain exceptions apply in bankruptcy and certain other procedures). LLC participants may sign a participants' agreement to regulate their rights. An LLC's charter capital determines the minimum scope of its assets, thus, guaranteeing the interests of its creditors, and must be at least RUB 10,000.

A full partnership is similar to an American-style general partnership, in which partners bear (full) joint and several liability for the partnership's obligations. A participant in a full partnership may not be a full partner in any other partnership. In contrast, a limited partnership, which is closer to the European-style "kommandit" partnership, has both full partners and partners whose liability is limited to their contributions. A full partner in a limited partnership may not be a full partner in another partnership, and its liability is the same as for full partners described above. Partnerships under Russian law are generally regarded as legal entities and are taxed accordingly. Contractual agreements for joint activity, although they share some of the characteristics of a general partnership, do not create a legal entity and there are special rules governing their tax treatment.

<sup>1</sup> The term "minimum monthly wage" is used by the government as a ratio to calculate different payments and does not reflect the real minimum wage. As of 1 January 2001, the minimum monthly wage was RUB 100.

## Tax matters

Russia's tax system is relatively young. So, many tax concepts and issues that are the norm in most market economies are just beginning to emerge in Russia. Moreover, even as the Russian tax authorities are beginning to embrace internationally accepted concepts, when it comes to applying them, they often diverge from standard practice in the West or other countries with developing tax systems. As of today, tax reform has largely been completed in terms of codifying the rules and eliminating multiple tiers of regulations. The Russian Tax Code summarises general taxation principles, as well as the rights and obligations of both taxpayers and the tax authorities, and provides descriptions of specific taxes.

The government plans to introduce a number of anti-tax avoidance rules (including controlled company legislation). But, in the meantime, the higher courts have outlined several anti-tax avoidance approaches, including the concept of unjustified tax benefits. The fiscal authorities are beginning to actively adopt these approaches and are cracking down on aggressive tax evasion. In doing so, they are beginning to use the substance over form approach. Overall, though, this is an area that is evolving rapidly. Several other key tax concepts are expected to be introduced, including profits tax consolidation and a significant upgrade of transfer pricing rules aimed at bringing them more into line with OECD guidelines.

Probably the most significant recent change in the Russian tax system was the repeal of the Unified Social Tax (UST), effective 1 January, 2010, and its replacement with mandatory social insurance contributions. These are assessed at a flat rate (in 2011, it is 34%, with some small businesses to be taxed under 26% rate). The key elements of the new social insurance contribution system generally coincide with their relevant UST counterparts. One major exception concerns foreign nationals temporarily working in Russia on employment or civil contracts, whose salaries and other forms of compensation are exempt from mandatory social insurance contributions.

Registration and tax residency. All legal entities in Russia must register with their local tax authorities, as well as in each location where they have a branch, a representative office, other separate subdivisions, real property or transport vehicles. An FLE must register with the Russian tax authorities at each location where it does business through a subdivision (whether or not the business activity is taxable) for any period of more than 30 days (cu-

mulative) during a calendar year. There are special registration requirements for FLEs that:

- a) own real property in Russia;
- b) own transport vehicles in Russia;
- c) have taxable movable property in Russia;
- d) have accounts with Russian banks.

Any company incorporated under Russian law is considered a Russian tax resident. There are currently proposals to change this so that resident status would depend on the company's "place of management," but it's still unclear when this amendment might be introduced or become law.

Tax treaties. As of year-end 2010, Russia was a signatory to 78 double taxation treaties (DTT), most of which are based on the OECD Model Treaty (although the UN Model Convention is still used by developing countries). All investors should be aware, though, that local Russian tax authorities generally do not have much experience in interpreting and applying DTTs. For determining the amount of profits taxable in Russia, some of these bilateral tax treaties offer more favourable rules for certain types of tax deductions. For example, the Russian-German DTT allows the unlimited deduction of advertising expenses.

Tax withholding. Under the Russian Tax Code, an FLE's earned income that is not derived from a permanent establishment (PE) in Russia is subject to withholding of Russian income tax at source. Tax withholding on interest, dividends and royalties are typically reduced by the relevant tax treaty. Treaty benefits can be claimed by any entity or person provided that the foreign company's tax residence certificate is available (no advance clearance is required to apply DTT provisions).

Tax incentives. Currently, taxpayers can take advantage of incentives granted either by regional or local authorities for the taxes they collect, or by special economic zones (SEZ) within Russia. SEZ residents are entitled to a number of tax benefits, such as reduced profits tax and exemptions from property and land taxes, and in some cases from customs duties and VAT as well. Regional incentives are granted to classes of taxpayers (typically large investors or entities operating in specific industries). However, the extent of regional incentives and the willingness of regional authorities to grant them have been diminishing over time.

**Transfer pricing.** Currently, the tax authorities may examine the prices applied in "controlled" transactions, meaning:

- transactions between related parties;
- barter transactions;
- foreign trade transactions;

- transactions in which prices fluctuated by more than 20% within a short period of time.

Prices used in such transactions may only be adjusted for tax purposes if they differ from the market price by more than 20%. The three methods available for determining market price are (in order of preference):

- the comparable uncontrolled price (CUP) method;
- the resale-minus method;
- the cost-plus method.

In February 2010, the State Duma (the lower house of Russia's parliament) passed on the first of three readings, a bill, introducing new transfer pricing rules. The bill is likely to become law in 2011 and take effect from January, 2012. If passed, it would make significant reductions in the list of transactions, where the Russian tax authorities can control prices for tax purposes. At the same time, it would also expand the list of related parties, abolish the current "safe harbour" provision (the allowable 20% deviation of controlled transaction prices from market prices), and introduce new market price determination methods, correlative adjustments for controllable transactions within Russia, and reporting and transfer pricing documentation requirements.

**Thin capitalisation rules.** Interest on loans received from foreign shareholders (as well as their Russian affiliates, or loans guaranteed by foreign shareholders or their Russian affiliates) holding a capital stake of more than 20% is deductible provided the loans do not exceed by three times the equity allocated to the given shareholder (or 12.5 times for banks and leasing companies). If the loans exceed this limit, however, the excess part of interest on the loans would qualify for taxation purposes as dividends paid to foreign shareholders. Such dividends are not deductible for profits tax purposes and are subject to withholding income tax at the rate of 15%. Benefits available under certain DTTs may serve to reduce this rate.

**Resolving tax disputes.** Probably the last thing you want to think about when making your Russian business plans is the potential for tax disputes. But, forewarned is forearmed, as they say. Tax disputes are quite common in Russia, so you should know what to do if it becomes an issue. Most corporate taxpayers have to go through the tax litigation process at least once while doing business in Russia. Currently, taxpayers can challenge the tax authorities' decisions and other documents/actions (or failure to act) either with a higher-level tax office or in court. Starting from 2009, one must first appeal certain types of tax authority decisions before the matter can be litigated. Unfortunately, however,

few tax disputes are resolved at the pre-litigation stage (administrative, higher tax office). Since taxpayers cannot negotiate tax audit results or enter into settlement agreements with the tax authorities, they usually have to turn to the courts to uphold their rights. Initially, arbitrazh courts of the first instance (i.e. lower-level courts) review disputes and issue decisions. Decisions by a first instance court can be appealed in appellate courts (second level) and cassational courts (third level). On average, litigating a single case (through all three court instances, or levels) usually takes from nine to twelve months. Although it is extremely rare, resolutions/decisions by these courts can be appealed to Russia's Supreme Arbitrazh Court.

Clearly, the investment process can trigger a whole range of questions. We think that investment decision-making should be based on a comprehensive analysis of all the myriad factors involved, ranging from purely commercial considerations right up to the relevant legal and tax implications. Although this approach does require considerable expenditure of time and resources, it has proven to be the best way for all parties to an investment transaction to avoid potentially costly mistakes and mitigate risks while getting the most benefit out of fresh, new opportunities.



## Labor Availability – Russian Peculiarities

Olga Bantsekina, Chief Representative, Coleman Service UK Ltd



### Olga Bantsekina

Olga Bantsekina is the Chief Representative with Coleman Service UK Ltd. Olga has been leading the company since 2001. She has more than 15 years of experience in recruitment and HR consulting, 12 of them with Coleman. Olga

joined Coleman Service in 1998 as an Account Manager; this was shortly after Coleman started its operations in Moscow. Subsequently, she was promoted to Business Development Manager; she then went on to become the General Director. Currently, she is the Chief Representative. Since 1998, the Company has become one of the leaders on the Russian recruitment market. Prior to joining Coleman, Olga worked as a consultant for an HR audit project in DialogBank. She also worked with Manpower as an Account Manager and has experience in managing an FMCG enterprise and a small privately owned IT service company.

Olga has been the Deputy Chairman of the Human Resources committee of the Association of European Businesses (AEB HR committee) for over 5 years and the Chairman of the AEB Recruitment sub-committee. In 2010, she was elected Chairman of the AEB HR committee.

Olga holds a degree in Genetic Engineering that she obtained from the Department of Chemistry of the Moscow State University n.a. Lomonosov. She has also successfully completed several executive and educational programs on leadership, management, sales, HR, recruitment (CBSD, CCL, Thunderbird, MTI, Manpower, FGI International (Women's Leadership Program in China)... and others.

Have you already made up your mind on investing in a Russian industrial enterprise or development project?

Are the strategies developed, targets set, project groups formed?

Have you already decided on a green- or brown field project? Did you find the exact place (or an enterprise) for your investment? Hope you did not do any, or all, of the above yet...

Though, in any case – please, take your time and think about the HR issues you will be forced to

deal with pretty soon – very soon I'd say – and much sooner than you might expect. Thus, it would be wiser to spend some time at the stage when you are still able to add some changes to your investment plans and adapt the structure of your project to the existing Russian reality. And the reality in terms of HR is going to be rather tough.

HR related issues are always the cornerstone for any business in any country in the world. At the same time, companies are often too imprudent and sometimes too naive to leave their planning till after the investment decisions are approved and endorsed.

From a consultant's point of view, prior to engaging in any project, be it Greenfield or Brownfield, a variety of planning activities must be undertaken in order to align the necessary resources and gauge the project efficiency. In this sense, human resources are as economically important a part of the project as time frames, supplier availability, project logistics and funds allocation.

First and foremost, Human Resources must be segmented and assessed before initiating projects that are either Greenfield (GFP) or Brownfield (BFP). The major segments are:

1. Headcount and budget planning;
2. Recruitment;
3. Compensation and Benefits;
4. Training and Development;
5. HR Record Keeping and Compliance.

### GFP/BFP – headcount and budget planning

Planning headcount and charting organizational structure is the first step in allocating Human Resources. This must be done in accordance with accepted market practice, internal requirements for organizational planning and current local labor market trends. These three elements are a pre-requisite in project cost planning. For example, failing to recognize the realities of the labor market may lead to prolonged personnel search and staffing problems, resulting in unpredictable project cost build-up.

Here you should be aware of the local regional labor market specifics, since there is no "general" labor situation in Russia, every region has its own peculiarities. It is dependant not only on the particular mentality of the locals, but also on the economic situation and investment climate, the quality

and quantity of educational institutions, quantity of major Russian and international companies operating on the local market, their business orientation, stage and prospects of development for new investment projects, and so on and so forth.

The problem is that despite the overall labor market development, there is still a lack of reliable HR related data, information and surveys, especially in the distant and small regions. Local market providers are (on the whole) Russian companies which are usually not able to correspond to international service standards.

On the other hand, major international service providers are not present in every region of this huge country, so you'll have to spend some time (and some money) for (a) survey(s) and you need to find a reliable provider with good quality service and appropriate data.

Still, it is worth doing at the stage of decision-making. Since in the end, when your factory in the most investment attractive region is almost ready to start production and your HR Director says that your staffing solutions cannot meet your production plans (e.g. his subordinates are not able to find the qualified line personnel within the one-day-drive limits), how much will you spend on a faster target achievement?

### **GFP/BFP – recruitment**

Assessment of labor availability is an integral part of headcount planning. Deciding on what set of qualifications recruited personnel must possess is very important. Inadequately qualified but cheap labor is liable to cause problems and increase the total project cost. As an alternative, temporary relocation might be more cost-efficient in the long run. The main pitfall here is the widespread resistance to being mobile (which is luckily changing, albeit slowly over the course of time).

Whether to recruit through agencies or directly is also part of economical equation, measuring recruitment speed (i.e. project schedule observance) against aggregate costs (recruitment costs vs. increased project costs by falling behind in staffing schedules). It is evident that in each specific case of a GF or BF project, a trusted HR consultancy must be retained to provide analysis/advisory notes.

### **GFP/BFP – compensation & benefits**

Once the headcount has been defined, budgets drafts made, labor availability assessed, there comes the question of defining compensation strategy.

It is customary to introduce a variable pay scheme when it comes to project fulfillment. This is a built-in motivator for personnel to adhere to schedules and budgets, thus keeping project costs at planned levels. However, in order to make a viable proportion between fixed and variable pay, as well as to offer a competitive package to attract the best talent, a specialized market overview must be obtained (the same situation, as with the general labor market info, for some regions it's not an easy task).

When planning your HR budgets for further development of your enterprise, you also have to take into consideration the average compensation levels for the personnel you need. In case you are investing into an existing enterprise, the salary levels for the employees on board might be far too deceptive and may be misleading. The huge difference between the green- and brown field projects in terms of HR has its roots here.

Being in the brown field, do not deceive yourself with the fact that you have greater numbers of employees than you are planning to employ. It may not mean anything. First (I would suggest doing it before acquisition, at least selectively) you have to assess those people and (hopefully not) you may find out that not many of them are qualified enough for your renovated production site. You'll either have to train them or to replace them with the more qualified (and much more expensive simultaneously!). Think twice and estimate thoroughly your possible HR expenses, not only compensation packages for your existing or future employees, but severance pay as well.

### **GFP/BFP – training & development**

It is not advisable to employ unskilled labor with a view to upgrading qualifications as you go along. Therefore the option (and cost!) of introducing this function must be carefully gauged against "over-paying" already qualified personnel.

### **GFP/BFP – HR record keeping & compliance**

Needless to say legal compliance in dealing with personnel must be ensured. To minimize legal risks, HR record keeping can either be outsourced or maintained within the Company by trained professionals. Once again, it is the question of costs, risks and quality that must be weighed and balanced.

Outsourcing (Outstaffing) is yet another instrument for keeping track of budget and resource allocation risks both for GFP/BFP. For example, project teams as well as line personnel and part of your

office staff can either be kept on-staff or outstaffed through agencies, as well as some functions in their entirety are nowadays available for outsourcing in Russia. Once again, the expediency of such options must be assessed from a cost control standpoint. The advisability of this option depends on many aspects, such as whether the company is customarily engaged in projects or not, whether production is exposed to fluctuations, whether the function to be outsourced may be controlled by an outside service provider, as well as on the numbers and qualifications of the employees you consider to outstaff, your production site peculiarities etc, etc.

Unfortunately, Russian labor legislation does not have the regulatory base for outstaffing/outsourcing services, so you also have to be very careful in choosing your consultant and potential service provider in this field in order to ensure your complete adherence to the Russian Labor Code.

Under these guidelines, the distinction between Greenfield and Brownfield projects is actually immaterial, since the approach to ensuring project efficiency in terms of HR is virtually the same. The BF projects have the advantage of accumulated data on previous experience. By comparison, GF pro-

jects are generally more fraught with risks that must be mitigated.

One of my friends and HR colleagues from an international industrial BFP (the company is now the owner of several factories in Russia) has once shared her opinion with me that if those were green field factories, the budget would have been saved to a certain extent... Though that is just a personal opinion of one HR Director (a well-known and respected one, but still)...

In the end, the success of the project will depend on the quality of project planning, organization and control. At each of the project stages, HR is a key factor that can't be underestimated.



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## Russia attracts investment through smart immigration policy

Ludmila Shiryaeva, Director, Human Capital department, Ernst & Young



**Ludmila Shiryaeva**

Ludmila Shiryaeva – Director, Tax & Law, Human Capital, Ernst&Young (CIS) B.V. Moscow.

Ludmila has 17 years of experience in advising clients on Russian income tax, immigration and labor law; social and pension contributions; cur-

rency and civil law; tax optimisation and planning; employment and payroll structuring; supervises the preparation of Russian personal income tax returns and deals with work permit applications for numerous corporate clients in various sectors; acts as an immigration practice leader and knowledge manager for the Human Capital group in Russia and as Chairwoman of the Migration Committee of Association of European Businesses, dealing with various issues in the immigration area, including meetings with government authorities.

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It is common knowledge that money does not travel by itself. In order to control and manage investments, companies send their top-level managers to set up new businesses and operations in new jurisdictions. Set-up periods require the involvement of highly qualified specialists who organise the process and educate local personnel in order to further transfer the responsibilities to locals.

This summer, Russia adopted a very progressive law establishing a simplified immigration procedure for highly qualified foreign specialists coming to work in the Russian Federation. The law was developed under direct instruction of Russian President Dmitry Medvedev, who in November, 2009 ordered the development of a new immigration policy allowing the attraction of talented foreign personnel within a short period of time, based on a fast tracked process for the issuance of Russian work permits and visas.

The new law, which came into effect on July 1<sup>st</sup>, 2010, was developed by various ministries and state bodies dealing with immigration and invest-

ment issues, including the Ministry of Economic Development, Federal Migration Service, Ministry of Healthcare and Social Development and Ministry of Education. Since July, 2010, the foreign companies doing business in Russia through branches and Russian subsidiaries, as well as Russian businesses employing foreigners, have already obtained more than 3,000 work permits for foreign Highly Qualified Specialists (HQS).

According to the Ministry of Economic Development, the expected annual number of HQS coming to work in Russia is 50,000–60,000 individuals. Thus, in July, 2011, it will be clear whether this forecast by the Ministry is correct.

Why is this law revolutionary; how will this impact the Russian economy and foreign and Russian businesses in Russia?

The general immigration procedure established for “regular” workers, is highly complicated, unpredictable, time consuming and administratively heavy. It consists of four main stages and a number of sub-stages requiring the involvement of various employment and immigration authorities. There is also a significant risk if the company planning to hire expatriates to work in Russia would assume that a process that has worked in the past would work again in the future, even where there are no formal technical changes in the current law. Thus, it is recommendable (at least at the beginning of the process) that the company be fully aware of all recent changes not only in the law, but in all the various practical approaches, requirements and procedures established by the authorities. However, there is no guarantee that these would not change again in the course of a work permit and visa application process.

The first stage that the company must pass in order to obtain an ordinary Russian work permit is the work permit quota application. To invite expatriates to work in Russia, the company must submit to the employment authorities, information regarding forecast of foreign labor needs (quota application) by May 1<sup>st</sup> of the previous calendar year. Such an application should contain information on each expected expatriate’s nationality and position within the company. Furthermore, the Russian government must approve that quota at multiple levels, and such approval is not guaranteed. It is rather difficult to predict far in advance the nationality and the role of the specialist. If the forecast is incorrect

and the specific quota, therefore, not approved, the authorities will refuse to issue a work permit. During the past three years, companies that had inaccuracies in their quota (or companies, which were newly formed and registered during the year, i.e. after the deadline of May 1<sup>st</sup>, were unable to attract the necessary personnel in time, or were even forced to arrange for the departure of expatriates and their families who were already living in Russia, but for whom the quota for the next year was not approved.

If the quota has been approved, the next step in the application process relates to the registration of the company with the employment authorities, who must be notified on a monthly basis about vacancies available at the company. Registering all the necessary information with the employment authorities, including the information regarding available vacancies will go a long way in positively influencing the final decision made with regard to the expediency of hiring foreign nationals, which is in turn, necessary for obtaining permits at the Federal Migration Service. Further steps relate to obtainment of the mentioned conclusion, corporate permits and (only then) individual work permits (each step takes about one month). Overall, the work permit application

process, depending on status of company's quota and availability of necessary documentation, may take from 3 to 24 months. The process is also complicated by the following requirements: necessity to provide official documents, including an apostilled copy of the diploma, confirming the expatriate's education and an obligation to pass numerous medical tests (under current requirements there are seven medical tests to be passed).

Generally, the immigration policy is aimed at protection of the local labour market, and this is relevant especially now, taking into account the post-crisis situation and the number of unemployed locals.

However, the current procedure established for regular foreign employees may not only make it impossible to attract the necessary foreign specialists, but also have the effect of reducing available opportunities for the employment of Russian nationals, rather than in any way, protecting them, as foreign companies operating in Russia also create work places for Russians via non-Russian managers. For example, the majority of subsidiaries of foreign organisations or joint ventures play an important role in developing regions by attracting investments and opening new companies employing local staff. The

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construction of big plants in regions leads to the development of new infrastructure, construction of residential apartments, attracting new workers. Thus, investors are carrying out city-forming activity.

In this context, it is difficult to underestimate the importance of the adoption of the new simplified rules with regard to highly qualified foreign specialists coming to invest in the Russian economy and develop new businesses and jobs.

In comparison with the standard procedure, the provisions made for HQS allow them to enter the Russian Federation without the prerequisite of obtaining a quota, decision on the expediency of hiring of foreign nationals, or a corporate permit for hiring foreign labour and submission of an apostilled copy of their diplomas and medical tests for invited specialists. Moreover, a HQS work permit and work visa are issued for 3 years, with the possibility to prolong these in the territory of Russia (regular immigration documents are valid for 1 year only; thus, the above-mentioned complicated procedure should be repeated by the company each year as many times as needed to ensure timely application for work permits, for all expatriates already working in the country or new comers).

The only criterion one must meet to qualify as a HQS is to have an official annual salary of not less than 2,000,000 Rubles per annum.

In addition to this minimum requirement, the new law establishes certain obligations for employers, including registration of HQS with the tax authorities and quarterly special payroll reporting obligations. The latter rule was introduced in order to control the use of this simplified regime by companies and re-confirm the HQS status of the individual, thus, his/her entitlement to the special procedures.

Furthermore, to make immigration more transparent and simple, the legislator introduced simplified rules for migration enrollment. Previous rules oblige the hosting party to enroll the individual within 3 days upon arrival in Russia (or to another location in Russia), and de-enroll within 2 days upon departure from the country (or from another region). This procedure is time consuming, as well as administratively tedious, and seems to be longer than necessary, as currently, the data base used by the Federal Migration Service and border-security authorities is sufficient for the controlling purposes. Thus, the new rule for migration enrollment introduced together with the HQS regime stating that expatriates need not be any longer de-enrolled while travelling within the territory of Russia somewhat reduces the administrative work of companies employing foreigners.

Taking into account the above-mentioned changes in immigration law, it is also worth mentioning that positive changes were likewise made in Russian tax law, as the same law on HQS also introduced the most beneficial tax rate available for HQS expatriates. They are now subject to 13% tax rate on their earnings in a HQS capacity from the first working day, irrespective of their tax residency status in Russia.

Finally, at the end of 2010, the Russian President signed another law with effect from February 15<sup>th</sup>, 2011, introducing further beneficial immigration rules for HQS and their families, in particular, allowing them to avoid a migration enrollment requirement for a stay of up to 90 days in Russia, or 30 days in another region. According to this new law, HQS expatriates may also enter the country under the simplified procedure not only with an accompanying spouse and children, as established now, but also with parents, grandparents and grandchildren (including adopted family members).

To summarize the above, currently, Russia is looking for and implementing numerous ways to improve the attractiveness of the country for potential investors, and to this end, substantial changes have already been made in the immigration and tax spheres. These changes are greatly appreciated and supported by Russian and foreign businesses employing expatriates in Russia, and various business associations including the Association of European Businesses, German Chamber of Commerce, Japanese Business Club and the American Chamber of Commerce,. The law itself has received positive feedback not only from various Russian government authorities, but also from the Minister of Economic Development Ms. Elvira Nabiullina, Prime Minister Vladimir Putin and President Dmitry Medvedev.



## Certified in Russia

Oscar Ozols, Business Development Director, Sercons



### Ozols Oskar

Ozols Oskar – Business development director Certification Authority LLC “SERCONS”.

Mr. O. Ozols has been with SERCONS since May, 2009. Over this period of time, he became the Head of the four largest departments within the

company:

- Department of Business Development and International Relations;
- Marketing Department;
- Department of CRM (client relationship management);
- Department of Information Security.

SERCONS today is the leading Russian company in the field of certification and expert appraisal of industrial safety, and in consultation with regard to certification and quality management systems introduction. The Company has its representatives in Russia and Europe, as well as in Turkey, Japan and Korea.

It should be mentioned that Oskar Ozols graduated from the Latvian State University, Department of Economics and Accounting Finance, having received the bachelor of economic sciences in 1998.

After university, Oskar Ozols went on to gain experience in the following organizations:

- European-Russian company “Office Park” as Commercial Director, Representative of the European investor;
- JSC “Interneta Pasaule” (Latvia) as Director of Business Development;
- Latvian-German enterprise “ORWO Baltic” (Latvia) as Commercial Director, co-owner;
- Latvian-German enterprise “HERMES Handelslogistic Riga” (Latvia) as Executive Director;
- Latvian-English JSC “BSB Trans” (Latvia) as Director.

*The Standards Institute in Russia remained in a state of stagnation for a long time, preserved from Soviet times. But over the past year and a half, Russia has experienced several events, which have influenced it strongly. The result is that “Russian standardisation” has entered a new era.*

## Background

The beginning of Russian certification can be dated back to the time of Peter I, and a decree given by him in 1722: *“To demand information from the magistrate on weights and measures, and to penalise in the event of the discovery of unbranded or incorrect weights and measures.” (1722)*

The certification process appeared as a systemic phenomenon only several centuries later, in Soviet times. In the mid 1960s, the All-Russian Scientific Research Institute for Certification (VNIIS) was founded, whose experts were engaged in standardisation and metrology. The specialists were given the task, *“to ensure the systematic monitoring of the consistency of product quality.”*

In 1979, the resolution of the CPSU Central Committee and the USSR Council of Ministers was published *“On the improvement of planning and intensification of the affect of the management mechanism to increase production efficiency and the quality of work.”* In 1984, the Soviet Union introduced certification on exported products. In 1988, the certification of mutually supplied products was introduced (the SEPRO CMEA system), which provided confirmation of the conformity to CMEA and international standards. In the same period, international accreditation and the certification of test laboratories appeared.

The “Russian” period of certification began in 1993, with the introduction of the law *“On consumer protection”*, which established the necessity to certify consumer products in accordance with safety and quality requirements. In the subsequent years, the legal framework was formed.

The main standard in the Soviet Union and later in the Russian Federation and the CIS countries was adopted as the State Standard (GOST), and approved by the International Council for Standardisation, Metrology and Certification.

The starting point in the modern history of certification in Russia can be dated to 2002, with the adoption of the Federal Law *“On technical regulation,”* which automatically repealed the previous laws *“On the certification of products and services,”* and *“On standardisation.”*

The desire to join the World Trade Organization (WTO) was the main impetus for the Russian government to launch the technical regulation reform, with the task of harmonising the national and European

systems of standardisation. The main idea was to gradually change the form of the confirmation of conformity for the majority of products, with the mandatory certification for the declared goods.

At this new stage, mandatory safety requirements, in accordance with the reform are now established in the new standards – technical regulations. The implementation of Soviet GOST standards' requirements remains mandatory during the transitional period, until the relevant technical regulations come into force. This extends to the protection of life and health of citizens, private and public property, the environment (including animals and plants), the notice of practices that could mislead consumers. After the technical regulations regarding this type of products come into force, the GOST standards can be applied voluntarily.

## History of development

It is worth saying a few words about the history of the development of technical regulation reform. The process caused a lot of fights and disputes and lasted for nearly a decade. There were two completely opposing opinions – for and against reform. For: because we would be closer to European standards, and against: due to the shortcomings of the law on technical regulation, and the inability to apply someone else's rules on our field of play.

As a result, just 11 regulations were adopted in nearly 7 years, and this is out of the several thousand which are necessary (the technical regulations for low-voltage equipment were examined for 5 years). During this time, about 6 billion a year was spent on reform. As a result, opponents started talking about returning to the GOST standards, whilst modernising them. However, progress was made. In late 2009, after another committee meeting on technical regulation, Russian President Dmitry Medvedev spoke rather sharply to the side responsible for reform and ordered them to “step up” the process. The impetus was now there. Even by the New Year, the State Duma had adopted a Federal Law on amendments to the law “On technical regulation”.

The Federal law was aimed at “improving the mechanism of technical regulation in the Russian Federation in order to create the conditions for the rapid reform of the regulatory framework, which establishes mandatory requirements for products and processes.” The ability to recognise and adopt the world's best standards for their use in the Russian Federation was enshrined in law.

Russia has set to work with renewed vigor on the development, review, and approval of its new stan-

dards. In December, 2010, more than 20 new technical regulations were approved, some of the major ones being “On the safety of wheeled transport,” “On the safety of machinery and equipment,” “On the safety of low-voltage equipment.”

When talking about the “recent history” of Russian certification we should mention the establishment of the Customs Union, which came into force on July 1<sup>st</sup>, 2010, and the integration of the economic space of three countries – Russia, Kazakhstan and Belarus.

The new union has the task of creating a united area in which goods can move freely. There are ambitious plans for the future – common certificates, a single accreditation for certification bodies, uniform standards – the technical regulations of the Customs Union. At the end of 2010, only one permit was approved, which is the same for all three countries – the certificate of state registration (conformity to sanitary-epidemiological norms).

So, today, given all the listed “baggage”, Russia has the following types of permits at its disposal:

### Certificate of conformity to GOST R / Technical Regulation

Certification is required to prove conformity of the product to the RF state standards and to execute customs supervision, in case of imported products. GOST R Certification is mandatory for any product manufactured in the RF or abroad (if imported to Russia).

But now Russia passes through the reforms connected with the federal act “About technical adjustment”. Therefore, new technical regulations are accepted. It is needed for the harmonisation of Russian and international standards. Certificates of conformity can be mandatory and voluntary.

The list of products, which are subject to mandatory certification (Certificate of conformity to GOST R) is given in decrees of the Federal Agency for Technical Regulating and Metrology (ROSTEKHREGULIROVANIE) of the RF. The products which are not indicated in ROSTEKHREGULIROVANIE decrees may be certified voluntarily.

A Government decree providing a new list of products subject to mandatory certification or assurance of conformity in the form of conformity declaration has been in effect since February 15<sup>th</sup>, 2010.

### Declaration of conformity to GOST R / Technical Regulation

The Russian Federation (RF) Government Resolution dated December 1<sup>st</sup>, 2009 No 982 came into

force on February 15<sup>th</sup>. The Resolution specifies a new list of products subject to mandatory certification and products subject to conformity assurance by making a declaration of conformity.

The list of products is posted on the web site of the Federal Agency on Technical Regulating and Metrology. An updated list of products subject to mandatory conformity assurance when placed under customs procedures is also posted on the Agency web site. The list specifies Foreign Economic Activity Commodity Nomenclature Codes.

Pursuant to the Federal Law "On technical regulating", any undertaking (a legal entity or an individual entrepreneur) registered in the Russian Federation under the legislation of the Russian Federation has the right to make a declaration of conformity.

The declaration of conformity may be made by:

- the manufacturer (a person acting as a manufacturer);
- for commercially available products, or for a batch of products, or a one-of-a-kind item;
- the seller – for a batch of products, or a one-of-a-kind item.

A company that makes a declaration must be a manufacturer (seller, supplier) of the declared products or it must exercise functions of a foreign manufacturer by virtue of an agreement with it insofar as the conformity of the products supplied and the responsibility for non-conformity of the products supplied to technical requirements are concerned.

It means that a foreign manufacturer is not allowed to self-declare conformity; the declaration can be made by a company selling these products (for a batch) or a person acting as a foreign manufacturer (for commercially available products).

When the declaration is drawn up, it must be registered. The Declaration of conformity is registered by an accredited certification body. An applicant sends a completed declaration and necessary documents to a company of its choice, whose accreditation scope covers these products.

The Declaration is registered upon a request for registration submitted by the applicant. An application form is prescribed by the document headlined "GOST-R Certifi-

cation System. Forms of the key Documents Used within the System".

### **GOST R Pattern Approval Certificate of measuring instruments (Metrology)**

The Pattern Approval Certificate of measuring instruments (also referred to as metrological certificate, measuring tools certificate, certificate for I&C) is a document issued by the Federal Agency for Technical Regulating and Metrology. It certifies that the given type of measuring tools is approved in accordance with the procedure established by the current legislation and conforms to the current requirements. Pattern Approval Certificate of measuring instruments is regulated by the Federal Law "On uniformity of measurements", No 102-FZ (amended as of June 26<sup>th</sup>, 2008).

Fire safety is regulated in Russia by the new technical regulation, Federal Law No. 123, which was approved and accepted on July 22<sup>nd</sup>, 2008, and which entered into force in May, 2009 – "On fire safety regulations".



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## **Fire Safety Certificate conformity to Technical Regulation**

Fire Safety Certification requires a product's conformity to the standards on Fire Safety – “Technical Regulations on Fire Safety Requirements”, which entered into force on May 1<sup>st</sup>, 2009. These standards are used for products manufactured in the RF and imported products.

The list of products, which are subject to mandatory certification (Certificate of Conformity to TR) is provided in the RF Decree No 241 dated March 17<sup>th</sup>, 2009. The goods which are not stated in the above mentioned decree can be certified voluntarily.

## **Declaration of Fire Safety conformity to Technical Regulation**

A declaration of fire safety is a form of confirmation of fire safety of an object that is valid on the territory of the Russian Federation, in accordance with the provisions of “Technical Regulations on Fire Safety Requirements” that entered into force on May 1<sup>st</sup>, 2009.

In the Fire Safety Declaration, the applicant (the Declarant) or the expert agency indicate which fire safety requirements have been fulfilled for the given object and in accordance with which legislative document. Also, the Declarant states that in the case of a fire, it is held liable for possible damage to health and/or property of the third parties, indicating the degree of compensation (financially or otherwise) for damages incurred in the event of an emergency situation.

## **Fire risk assessment**

A fire risk assessment might be conducted as one of the steps for the declaration of fire safety, or on a customer's request. The main purpose of Fire risk assessment is the compliance with fire safety requirements on object. The fire risk assessment intends, particularly, to get the unbiased information on current condition of fire safety of the object and improve the protection level.

## **GOST R Explosion-Proof Certificate**

Technical devices, including foreign-manufactured, used in hazardous production facilities should be certified to prove their conformity to the industrial safety requirements set by the Russian Federation Law. The lists of technical devices used in hazardous production facilities and subject to certification

are elaborated and approved according to the procedure established by the Government of the Russian Federation (List approved by ROSTEKHNADZOR of the RF and GOSSTANDART of the RF dated August 3<sup>rd</sup> and 10<sup>th</sup>, 2001).

## **Certificate of state registration of Customs Union**

Since the coming into force of the Customs Union of Russia, Belarus and Kazakhstan on July 1<sup>st</sup>, 201, all decisions with regard to the execution of sanitary – epidemiological measures have been stopped. The document, confirming the quality and safety of the product is now a certificate of state registration of the Customs Union (CSR CU), which will be valid on the territory of the Customs Union of the three countries (Russia, Republic of Belarus, Kazakhstan).

The certificate of state registration, sustaining the safety of products, which is a single form issued by the Federal Service for Supervision of Consumer Rights Protection and Human Welfare has been added to the narrow list of products – this procedure may be exercised by the territorial bodies of the Rospotrebnadzor.

## **Registration of Medical Products**

**Registration Certificate of the Ministry of Health and Social Development** is a document that must be obtained for medical products and medical equipment. This certificate confirms the official registration of medical products. Medical products cannot be used in healthcare without first being registered with the Ministry of Healthcare and Social Development.

The company SERCONS offers services on the execution and issuance of registration certificates for medical products, as well as medical equipment, pharmaceutical raw materials and by implication, for drugs.

As of today, certificates of Belarus (BelST), Kazakhstan (GOST R) and Ukraine (UkrSEPRO) are still being given out.

## **BELST Certificate (Belarus)**

BELST – Belorussian expert appraisal – was developed in 1992. Depending on the situation, the BELST certificate can be either mandatory or voluntary. Consumer goods, goods and services that pose a potential hazard to life, health or the property of citizens, and a potential danger to the environment are subject to mandatory certification.

## **UkrSEPRO Certificate (Ukraine)**

The UkrSERPO Certification system – is a Ukrainian system of standards. It is analogous to the Russian System GOST. The UkrSERPO certificate proves conformity of certified products (services) to the stated requirements and standards. UkrSERPO can also be mandatory or voluntary.

## **GOST K Certificate (Kazakhstan)**

The GOST K Certificate (Kazakhstan) is applied to product importation into Kazakhstan and exportation to Russia. The GOST K certificate proves conformity of certified products (services) to the stated requirements and standards. The secondary objective of the GOST K certificate is to conform to the recognition procedure carried out when exported products must be accompanied by a foreign certificate of conformity.

## **Letter of Refusal**

A refusal letter is an official document issued by a certification authority, which states that no mandatory certification is required for a particular product or that the product belongs to a group of products whose compliance can be confirmed with a compliance declaration. A refusal letter must be written on the letterhead of the authority that issues it and must bear the coat of arms seal of the said authority. It follows from the above that there can be two kinds of refusal letters – for customs and for business partners.

Until recently, the issuance of Letters of Refusal for Customs engaged the Ministry of Industry and Trade. In mid-December, 2010, the Ministry was relieved of these obligations.

We should also talk about the system of industrial safety, acting on the territory of the Russian Federation.

## **Permit for Use of the Federal Service for Ecological, Technological and Atomic Supervision of the Russian Federation (ROSTEKHNADZOR)**

A permit for the use of ROSTEKHNADZOR (also known as: Permission for the right to utilise technical tools, Permission of ROSTEKHNADZOR) is a document confirming correspondence of equipment (technical device, material) including equipment of foreign manufacture to the requirements in the field of industrial safety and permits appliance

(exploitation) of such equipment in hazardous production facilities, controlled by ROSTEKHNADZOR.

To obtain the ROSTEKHNADZOR Permit for Use you should also have the three year Obligatory Certificate of Conformity for Serial Production. If you haven't already got this certificate we will obtain it for you and afterwards we will carry out the technical test on your device security. Certain types of products also are required to have a Certificate of Fire Safety, Metrology Certificate, Explosion Safety Certificate and Certificate of state registration of the Customs Union.

## **Industrial Safety Expert Appraisal**

The Industrial Safety Expert Appraisal is held to prove that the object appraised conforms to the requirements and rules of industrial safety. As a result of such appraisal, an industrial safety Conclusion is issued. On the basis of the expert appraisal report, ROSTEKHNADZOR issues the Permit of Use.

Object Appraisal – is project documentation, technical equipment, buildings and constructions on hazard production facility, industrial safety declarations and other documents relevant to hazard production facility exploitation.

An appraisal report is a document with valid conclusions of correspondence or disparity of the object appraisal to industrial safety requirements in order to receive the Permit of Use (the present conclusion is just a recommendation in the Russian legislation; in, practice the regulatory authorities require that it be obligatory).

According to present legislation, the expert organisation is licensed by ROSTEKHNADZOR to perform the industrial safety expert appraisal.

When the equipment is used in hazardous production facilities, it must be tested before use. The documents with regard to testing include special testing programs and methods (in conformity with Rostekhnadzor). Testing programs are issued on the basis of the requirements specification, in-line and engineering documentation. All sort of typical methods, programs and other referenced data are also used.

This is roughly the “picture” that the Russian standardisation market has painted as we enter 2011. However, the pace of change has gained such speed that unfortunately, it is hard for the authors of this article to predict what state Russian certification will be in at the time this publication is in circulation. To be continued...

## ISSUES DURING AN AQUISITION

### Financing a transaction

Dr. Vladimir Ismailov, CFO, Moscow School of Management Skolkovo



#### Dr. Vladimir Ismailov

Dr. Vladimir Ismailov is the Chief Financial Officer with the Moscow School of Management SKOLKOVO, supporting a range of corporate business- functions of the School that provide MBA, Executive MBA, Executive Education, Research

and consulting focused on emerging market business and government agencies and organizations. Vladimir teaches Finance to SKOLKOVO students.

He holds a PhD in Economics. Dr. Ismailov is also a Certified Auditor of the Russian Federation and Member of the American Institute of CPA. Dr. Ismailov has a great deal of financial and auditing experience in several business sectors, having worked in the Media & Information, OEM, Telecom services sectors, as well as in non profit organizations.

Vladimir is the author of a number of publications on general economics and investments. He was also the Chief Editor of and is one of the contributors to the annual guide for investors – “How to Invest in Russia” published by the Association of European Businesses in the Russian Federation in English and German in 2007–2010. Dr. Ismailov also cooperates with major media (BBC Russia Radio, Russia Today TV, City FM Radio, Kommersant Radio etc.) in Russia and abroad as member of the panel of experts that opine on investments and the business environment in Russia. Dr. Ismailov teaches Basic Finance and International Corporate Finance. He is also a member of the Moscow City Consultative Council on Creating an International and National Financial Center in Moscow.

Area of expertise – foreign investments in Russia, Corporate Finance, Financial management, project management, not for profit organisations etc.

While developing business plans for your new or expanding business, it is important to have a clear understanding about the sources of financing that are available to companies in Russia and the “local” specifics associated with some of them.

Limited cash resources may restrict a company’s ability to meet its business objectives, and

therefore, may lower returns, damage public image and negatively impact the company’s value. Excess cash and/or access to inexpensive capital may represent an opportunity to increase the effectiveness of the business through a balanced investment program, ability to seize an attractive business opportunity that may present itself in the market, improve a business image and may become a good leverage tool in internal discussions amongst top managers, the board and shareholders.

Most companies in Russia are similar to companies throughout the world in trying to find a balance between various funding options and the advantages and disadvantages related to them.

#### Types of short-term financing tools

Examples of short-term funding instruments may include:

- Cash;
- Short-term investments (deposits, loans given, shares bought for sale etc.);
- Accounts receivable;
- Accounts payable;
- Bank overdraft facilities;
- Factoring arrangements, etc.

Most companies in Russia use only the first two instruments extensively, thus, overlooking the great potential for additional cash flow through other types of short-term financing. For example, it is hard for managers of companies working in Russia (as in other parts of the world) to appreciate the advantages of micromanagement of receivables and payables. Some financing options may not be very well known to the market and/or there may be no legal infrastructure to support them. For example, factoring is still a relatively new tool in Russia and the legal framework for this instrument is still in the developmental stage.

On the other hand, the banking industry in Russia is very heavily regulated. The prime regulator for all banks is the Central Bank of Russia (CBR). The CBR dictates industry rules, monitors compliance, issues and revokes banking licenses, controls cross border and capital transactions, and micromanages the foreign exchange mechanism, including exchange rates.

**Bank overdraft facilities** are very uncommon in Russia, primarily due to the underdeveloped credit



risk system in Russian banks. Some local banks are not keen on implementing financial instruments that are uncommon due to a lack of internal culture and unclear regulation from the CBR.

Therefore, before choosing a short-term instrument for financing a business, it is important to assess the capabilities of the internal resources (not just financial, but also HR, IT etc.), the capability of the local management who will have to carry out daily micromanagement of the situation, as well as external factors such as the capabilities of counterparties (banks, clients, vendors etc.) and level of risk that the company is willing to tolerate.

### Types of long-term financing tools

Examples of long-term funding options may include:

- Bank loans;
- Fixed income financial instruments (bonds etc.);
- Derivatives (futures, swaps, hedging contracts etc.);
- Leasing arrangements;
- Retained earnings and reserves;
- Quasi-equity financing tools (convertible debentures, subordinated debentures etc.);
- Equity financing (preferred shares, common shares, options and warrants etc.).

Again, only some are commonly used in Russia. Others are still a “premier league” attribute that are used by companies that have the resources to set up the relevant legal and tax structure, hire skilful finance and executive staff who can micromanage these instruments on a daily basis.

**Bank loans** are probably the most common long-term financing tool. However, interest rates for bank loans are marginally higher than those in Europe and the United States. Another factor to consider when using a loan from a Russian bank is the requirement in relation to the accrual for bad debts that any bank in Russia must adhere to at the risk of losing its banking license. Any change in a business viability or sharp negative deviation in revenue and/or profitability may raise doubts on the bank’s side and/or result in a breach of loan covenants, and the bank will have to provide for such a loan in its balance sheet. This requirement imposed by Central Bank of Russia requires banks to act swiftly, and thus, limits their flexibility in loan restructuring. These specifics were the most interesting aspects of the loan market during the liquidity crisis in Russia in late 2008 – early 2009.

**The bond market** in Russia has developed into a sizable tool for less expensive funding and less risky investments. Despite the crisis, or maybe because of it, the market expanded. The FinamBonds

index (FB-Total) grew from 196,5722 on November 1<sup>st</sup>, 2008 to 253,7847 on October 30<sup>th</sup>, 2009. Unfortunately, the number of defaults has also increased significantly.

**Quasi-equity financing instruments**, such as convertible debentures and subordinated debentures are still rather new to Russian companies. These instruments do not have a specific definition in legislative documents. This means that such instruments can be regulated either in Russia by a contract or be arranged for and regulated by the foreign jurisdiction legislative. Although the use of such instruments is possible it entails substantial fixed costs in the case of the involvement of a foreign legal entity and is quite cumbersome to manage in Russia based on a contract.

Before making a decision on the preferred type of funding one should carefully consider various aspects of the project:

- The existence of a developed market for the particular type of funding. For example, the residential mortgage-backed securities (RMBS) and commercial mortgage-backed securities (CMBS) deals are just entering the Russian fixed income market.
- The existing legal framework (licensing, compliance with cross border funding regulations etc.).
- The time required to arrange the receipt of funds (some types of funding, for example, increasing the share capital, may take several months to arrange).
- The availability of internal non-cash resources to support the project (a legal department to draft the necessary documents; a finance team that can work closely with banks, a business model and strategy that supports assumptions and scenarios, etc.).
- The presence of qualified consultants (investment bankers, lawyers, etc.) who may support the need for funding.
- The availability of a credit history, ideally supported by a credit rating and corporate governance score from a well recognized agency.

Despite the fact that *equity* and *debt financing* are very complicated areas of business management, Russian companies and even local subsidiaries of multi-national companies are moving into the corporate debt market very swiftly. Most companies used equity financing as their prime source of funding in previous years. An equity infusion normally requires substantial paperwork. A company needs to execute not just documents in order to comply with the needs of corporate governance, but also ensure that the necessary tax filings are performed. In the

case of cross-border funding (for example, a parent company providing funding to its subsidiary in Russia to finance a transaction), the corporation needs to take into account the currency control regulations set by the CBR that banks are required to rigorously observe.

However, mature capital markets in Russia demand that participants be more creative than before in order to access capital markets and find financial instruments that suit their needs.

Local companies usually place debt and equity instruments at local exchanges (RTS and MICEX) and/or international debt and equity markets. The European capital markets were attracting a significantly larger number of equity placements than the US or any other markets before the crisis. This is due primarily to the more rigorous regulations at the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ) introduced by the Securities and Exchange Commission (SEC) after the well-known series of corporate fraud scandals. However, European countries are actively discussing restrictive measures against extremely active foreign investors. This primarily concerns government investments from emerging markets and Russian companies with international business interests. This may eventually divert the interest of Russian companies to Asian markets, particularly, Hong Kong and Singapore. As many as five Russian companies may follow United Co. Rusal and list in Hong Kong by 2012 according to opinion by VTB Capital and about six companies are considering listing in Singapore according to Michael Tay from Russian-Singapore Business Forum. .

Financing your business in Russia is just as challenging as in any other market. Before making a decision in favour of a particular strategy, one should fully assess the pros and cons of each scenario. Even though there are plenty of skilful advisors available in the market, the ultimate decision will be left for the owner(s) of the business.

## 8 Steps to facilitate better protection against tax risks in share purchase agreements when making an acquisition in Russia

Andrey Shpak, Tax Partner, Goltsblat BLP



### Andrey Shpak

Andrey Shpak heads the Goltsblat BLP (part of Berwin Leighton Paisner) Russian Tax Practice.

Andrey has 15 years of experience in helping Russian and foreign multinationals streamline their tax and legal structures in Russia, as well as assisting clients through all phases of acquisition (due diligence, structuring, completion), as well as in preparation of sale of Russian business to foreign investors. Andrey has been recently focusing on complex multi-territory and private-equity-backed transactions.

Andrey is one of the leading experts in Russia on advising clients on the tax aspects of Share Purchase Agreements (SPA), suggesting the right level of tax warranties and indemnities to be written into the SPA, as well as suggesting ways to achieve tax favourable result on any payments envisioned by the SPA.

### Introduction

Even if every precaution is taken, tax risks are still likely to feature in any Russian deal made by European investors in Russia. In most cases, the risks involved are difficult to eliminate completely; therefore, extensive use of proper sale purchase agreement covenants, warranties and indemnities is crucial.

Although it is not possible to outline all the potential nuances of obtaining contractual protection against tax risks in deals, I have tried to summarise below certain core elements of such protection in share purchase agreements (SPA) that are essential when making acquisitions in Russia.

These observations are primarily with regard to SPAs made under English law (the use of which is common in many large- and medium-sized deals in Russia), but with some modifications, may also apply to SPAs made within the framework of a different law.

#### 1. Start with structural protection

The first step in protecting your new acquisition from tax risks is to try to minimise the number of potential risks you take when acquiring a business.

This may potentially involve excluding some legal entities from the target structure, transferring

some parts of the acquired business to new legal entities prior to acquisition, or requiring the vendor to discontinue dubious tax practices prior to acquisition.

This will reduce and limit the number of potential problems. In my experience, a significant number of acquisitions of non-public Russian companies include implementing some form of the above measures prior to acquisition; indeed, these steps are often given as “conditions precedent” in SPA.

#### 2. Ask for explicit “euro-for-euro” tax indemnity

You should always try to obtain an explicit tax indemnity for all tax risks that may crystallise post-completion as a result of events occurring or deemed to have occurred prior to completion. Such indemnity should give you “euro-for-euro” compensation for any tax costs that crystallise post-completion – with minimal exceptions. Such tax indemnity should be the focal point of any proper contractual protection against pre-completion tax risks.

It is important to understand that having a set of tax warranties does not necessarily constitute a substitute for proper indemnity for two reasons:

- making claims under warranties is more difficult procedurally; and
- warranties can typically be limited by disclosure of information prior to signing/completion; such limitation by disclosure should generally not apply to indemnity.

Small and medium-sized businesses, however, tend to resist providing comprehensive tax indemnity and often accept indemnity only against individual risks identified as part of tax due diligence.

#### 3. Limitation period for tax indemnity

Russian tax law allows tax authorities to perform an audit three calendar years preceding the year when the audit is initiated. This means that, for example, for a deal completed in October 2009, the tax authorities may initiate a tax audit as late as 31 December, 2012, covering some periods pre-completion. In addition, related tax audit proceedings may extend into 2013 (and occasionally even further).

It is also important to understand that, in the majority of cases, periods already audited may technically be re-audited again in the future by a higher level tax authority. Therefore, having a particular tax period



already covered by a tax audit does not necessarily give you, as the purchaser, complete protection.

For this reason, it is market practice in major transactions to request that any tax indemnity should apply to at least four calendar years post-completion.

Small and medium-sized businesses, however, tend to insist on shorter limitation period (one-two years). In this case, proper pre-deal tax due diligence becomes extremely important.

#### **4. Be selective as to who gives indemnity and properly choose the compensation (indemnity) mechanism**

It is not uncommon for Russian vendors to have holding structures that include foreign vehicles. Such a foreign holding vehicle may be the formal party to the deal, but own no assets post-completion, and may therefore, have insufficient funds to cover any potential tax claims.

Therefore, in many cases, the indemnity mechanism in a Russian deal is more comprehensive and diverse compared to deals in certain other jurisdictions. It often uses several elements, for example, deferred compensation, escrow accounts, and personal guarantees from the ultimate owners etc. as additional protection.

#### **5. Ensure that proper tax gross-up clauses are included**

Russian tax law does not specifically address how payment under indemnities should be treated. Therefore, it is important to make sure that you, as the purchaser, are properly compensated on an after-tax basis. In order to achieve this, you should place on the vendor the burden of any potential tax costs related to paying compensation for post-completion tax claims. This may be achieved by including an appropriate tax gross-up clause into the SPA applicable to payments under indemnities.

#### **6. Ask for a comprehensive and detailed set of tax warranties**

Although, as mentioned above, you should always try to obtain proper tax indemnity (covenant) in an SPA (with minimal limitations and exceptions), it is still advisable to have the vendor give an extensive set of tax warranties as additional protection.

A sophisticated Russian vendor would typically try to have tax warranties that concentrate on confirming only that the tax returns are true and accurate and that tax has been fully paid under these tax returns, rather than accepting full responsibility for tax relating to pre-completion periods.

Such a narrow approach potentially allows the vendor to attempt to rely on formalistic arguments in resisting warranty claims, and thus, exposes the purchaser to risk in a variety of situations, for example:

- a) Russian tax law is notorious for being open to interpretation; there may be situations where a tax assessment is made, but arguments to support the vendor's position nevertheless remain; and thus, constitute a basis for the vendor to dispute any warranty claims;
- b) the tax assessment can be initiated directly by the tax office rather than by the taxpayer through a tax return (as may be the case with transfer pricing or the reclassification of aggressive tax schemes), in which case there will be no technical breach of warranty; or
- c) tax for the pre-completion period may arise as a result of a post-completion event (e.g., as a result of the allocation of revenue under a multi-period contract).

#### **7. Insist that disclosures be specific and quantifiable**

It is common for Russian vendors and their lawyers to attempt to provide numerous documents as disclosures prior to completion that are often only vaguely relevant, not sufficiently explicit, not necessarily quantifiable, or which include very general references to "areas of exposure".

It is important to resist such disclosures, and insist that only disclosures that are sufficiently specific and quantifiable will be accepted.

Some sophisticated vendors also try to include provisions limiting any liability under tax indemnity with disclosures. Such an approach should be resisted: by definition, only tax warranties should be subject to limitation by disclosures.

#### **8. Make collection against tax claims under indemnity easy for you**

Tax assessments issued by Russian tax authorities are often disputed in court, and court proceedings may take a year or more.

In this context, it is important to ensure that if such a tax assessment is raised, you as the purchaser are entitled to bring a claim against the vendor immediately upon receipt of such assessment – you are not required to wait until the issue is finally settled in court.

## Key changes to Russian tax law in 2011

Andrey Shpak, Tax Partner, Goltsblat BLP

Numerous changes were introduced to the Russian tax legislation recently, which become effective in 2011. We selected the key 5 changes that may be relevant to making deals or an investment in Russia.

### 1. Capital gains on some types of shares exempt from Russian tax

Capital gains on shares in Russian companies that have been held for more than 5 years are now exempt from Russian tax provided that shares

- a) have not been publicly traded during the holding period; or
- b) are publicly traded and the company being sold was operating in the high technology sector during the holding period; or
- c) were not publicly traded when acquired, but at the moment of sale are publicly traded and the company being sold operates in the high technology sector.

This provides new and interesting opportunities for structuring Russian investments through Russian holding companies (given the domestic divi-

dend participation exemption that was significantly expanded in 2010), especially, in the high-technology sectors.

### 2. Interest deductibility limit significantly reduced for loans in foreign currency

Historically, Russia has been relatively generous when establishing limitations on deductibility of interest – the interest deductibility cap on foreign loans for more than 15 years has never been below 15%.

This was very useful in planning acquisition structures, and with proper planning, allowed to get substantial tax shield on taxation of your investment in Russia once it was properly leveraged.

However, from 1 January, 2011, the interest deductibility cap was reduced from 15% per annum (pa) to 0.8 multiple of the Central Bank of Russia rate – i.e. based on the current Central Bank rate, effectively to 6.2% pa.

If your existing loans (or the loans you plan to attract to finance or acquire the Russian business) are denominated in foreign currency and bear an

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Liberty Jack, 2008, Jamey Forgan © V&A Images

interest higher than the above threshold, you will be affected.

There two key possible solutions to the issue are

- a) replacing loans in foreign currency to loans denominated in Russian Roubles, where the interest cap is retained at the level of 1.8 of the Central Bank of Russia (CBR) rate ie based on the current CBR rate, effectively at 13.95% pa; and
- b) rely on provisions of some of the double tax treaties that allow allows for full deduction of arms-length interest, if the Russian borrower is owned by a parent resident in the treaty country (such benefits are granted by the treaties with Netherlands, UK, Germany, Belgium, New Zealand, Canada and France).

### **3. Protocol to the Cyprus-Russia double tax treaty signed, potentially decreasing the attractiveness of Cyprus as a holding location**

On 7 October, 2010, the governments of Russia and Cyprus signed a protocol to the Russia – Cyprus double tax treaty. As of the time of this publication the protocol has not come into force, but its provisions will apply from 1 January of the year in which all formal approval processes are completed.

The most significant changes introduced by the Protocol include:

1. Taxation of capital gains on sale of shares deriving more than 50% of their value from immovable property;
2. Admissibility of thin capitalisation rules;
3. Withholding taxes that apply to income from mutual investment funds;
4. Broader opportunities for information exchange and tax collection assistance;
5. The required investment threshold for a reduced tax rate for dividends, which is now is set at Euro 100,000;
6. More extensive procedure for the determination of the place of effective management;
7. New limitation of benefits article;
8. New, extended permanent establishment criterion for services provided through individuals.

The new provisions, once they come into force, will require exercising greater care to the structuring and management of Cyprus holding companies, if you intend to use them in your acquisition/holding structure for Russian investment

### **4. Skolkovo area tax benefits to innovation companies clarified**

The law now clarifies the tax benefits for Skolkovo innovation project participants – which should be Russian legal entities, established exclusively for

the activities referred to in these laws and included in the special participants' register for 10 years.

The benefits include:

- a) the choice of not having to keep Russian statutory accounting records, unless their annual sales proceeds exceed 1 billion (bln) Roubles, provided the company maintains records in line with the requirements of the Russian Tax Code;
- b) no profits tax until their annual proceeds exceed 1 million (mln) Roubles, and after that – profits tax of 0% until the year in which their profits top 300 mln Roubles;
- c) no value added tax (VAT) – except on goods imports into Russia – or property tax, until their aggregate profits exceed 300 mln Roubles from the beginning of the year in which their sales proceeds top 1 bln Roubles;
- d) to the option of paying insurance contributions only to the Pension Fund of the Russian Federation at a 14% rate (from 1 January, 2011) until the 300 mln Roubles profits mark is reached.

This may be relevant if you consider performing Research and Development (R&D) activities in Russia that also target the Russian market.

### **5. Profits tax exemption for contribution of assets aimed at increasing net assets**


The contribution of assets or property rights by shareholders with the specific aim of increasing the net assets of a Russian company (even if this does not result in a formal increase of charter capital) is no longer subject to Russian profits tax. This should help eliminate some of the historic tax difficulties which foreign investors faced when devising structures aimed at improving the statutory net assets of their Russian subsidiaries (this, for example, can be an issue for leveraged subsidiaries in case of abrupt Rouble devaluation, as was the case in 2008), where tax-exempt charter capital contribution had not been available in some cases for regulatory reasons.

For example, previously, in similar circumstances, profits tax exemption applied solely to transfer of property by a controlling (more than 50%) shareholder. Also, there were doubts as to whether forgiveness of interest qualifies for a profits tax exemption. The new provisions should allow one to avoid these issues.

# POST-AQUISITION ASPECTS OF INVESTING IN RUSSIA

## Post-acquisition aspects of investing in Russia

Rainer Stawinoga, Partner, Russia Consulting



**Rainer Stawinoga**  
 Rainer Stawinoga is Partner in one of the leading Accounting, Tax and Payroll Outsourcing Companies in the CIS. He is certified in IFRS and has extensive knowledge in IT for accountancy. In more than 14 years of experience in the region, from Georgia over Moldavia to Russia he has deep experience not only in accountancy and taxes, but also in Due Diligences and all kind of organizational and managerial questions. Working before as a Partner of PwC in Paris he brings multicultural experience as well as the knowledge of small and big organizations. He knows industrial and distribution sector as well as financial activities, telecom or energy.

After having bought a Russian company or assets of a production company, including personal and those of clients, foreign investors are faced to the question of managing the new subsidiary. Basically, the difference between establishing a new company and dealing with existing structures is not that significant, in the case of the latter, the investors must deal with existing habitudes, unwritten engagements and a different company culture, which makes management more difficult. This is why many mergers or acquisitions are not successful.

Traditionally, the areas to handle with can be split as follows: selling, producing, administrating.

### Selling

Every country has its own in particular distribution circuits...so has Russia. Newcomers on the market are faced with traditional problems like being in con-

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currence with personal connections and reliability, based on long-term relationship and trust coming from reliability. As in every foreign country, the investor has to find a the right balance between Russian managers who have a good knowledge of the Russian market and its clients' needs and commercial habitudes on the one hand and foreign competence or technology brought in by the investor and his employees on the other.

Logistic is quite a big problem for selling because of long distances, the strong and sometimes difficult climatic conditions, for example, in Siberia the temperature can fall to minus fifty or even below and in the summer, it can be above forty degrees. Also, the transport system is not as well-structured as that of Western Europe; roads are not in such a good shape and especially as a result of the above mentioned issue of climate. Many companies face the problem of being able to supply as distribution of a distance of more than a thousand kilometers becomes very problematic or impossible.

Import is another problem as the customs services are not very performant.

### **Production**

When buying or building a factory companies are faced with multiple problems, which are partially similar to those existing in Western Europe, but might be even more difficult in Russia. One of those is the issue of getting administrative authorizations. Depending on the nature of a company, there are a several authorizations that must be obtained prior to it being able to legally function on the Russian market. Usually, the authorizations are many in number, which brings up the issue of time, and this is very important to the investor. It is not unusual to witness a situation whereby a factory/company, though ready to commence operations, has to wait for two years to receive all the necessary authorizations. Also authorizations might be difficult to get because technical requirements might change during the authorization process. For example, when a factory is constructed, the company might apply the existing rules. However, two or three years later, on receiving the authorization, the rules might have changed and, the factory/company may be found to no longer conform to official standards, under the new rules.

Environmental questions are quite new in Russia and the companies have to learn how to handle this. In the past, little attention was paid to environmental aspects; today, legislation is being drawn up to that effect. When buying factories, the investors do not take into account the existing environmental

pollution, as well as that incurred by the factory prior to its purchase. This has led to many a situation, whereby, in addition to having to deal with the issue of environmental pollution, the investor may also have to bear responsibility for the damage to the environment brought about by the factory in the past, i.e. prior to the purchase. At the moment, there is no best way to resolve such a matter, should it arise; many a time, a good relationship with the authorities goes a long way in facilitating a mutually beneficial solution.

Modernization is also quite an important point. Many factories, when bought, are not in a very good technical shape. Even when equipped with equipment with the latest technology, the building structure itself may make it impossible to successfully connect to electricity, water and gas and other amenities such as the internet or even telephone. This is where modernization comes in, not only in terms of technical issues, but also with respect to educating the workers on how to use the new equipment and on work place behavior in general. Here again, support from the Russian Authorities might be very helpful. Some foreign investors are engaged in joint ventures with Russian companies and an important task for the investor is to modernize production means. This means not just introducing new technology, but reorganize the entire production process as well, to build up new competence in the area of human resources and to introduce quality standards. Quality and quality assurance is again something quite new in Russia. This is parallel to the problem of product imitation, which is still quite common in Russia. There are situations where the company, when checking bought goods, finds 30% of goods which are in conformity with expected standards. Specialists in quality control already exist in Russia; they are in general subsidiaries of foreign existing companies.

### **Administration**

#### **HR**

One of the most important problems facing investors is in human resources. This means it is not easy to find managers who are familiar with both Russian and Western management style and management tools and also speak at least one other foreign language. An additional typical Russian problem is reliability – when recruiting one must make sure that the managers are loyal and sincere. This situation will become more critical in the future, as the number of working people in Russia will significantly decrease in the next five years. So even if the foreign companies present in Russia make a lot of effort to

train people, it is still difficult to find the required persons. Western recruiting companies are very helpful; however, it is very difficult to find people with the necessary experience and skills, especially, in small towns. One typical problem is a basic lack of understanding between the Russian Chief Accountants and the financial services of the mother company, as a result of the difference in accounting principles and attitude to tax authorities.

### **Management information system**

To run a company, managers need information. In Western Europe, the Management Information System has been elaborated over many years. In all countries, accounting is the base of the management information system. Even if the managers are not interested really in accountancy itself, everybody needs it to manage and operate the company. Management Information Systems are based on one hand on accountancy and the other hand on Information Technology (IT). As Russian accountancy is strongly influenced by tax considerations, it does not give a true and fair view of the situation; thus, additional tools and methods must be developed. This is achieved through IT developments and very often the use of programs like SAP, Axapta, Navision and others. The domination of the Russian accounting program 1C, which is not at all management oriented and very difficult to use (can only be used by well trained Russian accountants), does not make things more easy. This program, because of its tax relevance, is quite unavoidable in Russia. If, however, management tools should be developed on this basis, this is costly to obtain and manage.

Related IT developments are quite often without written documentation. This is a specific task and of specific difficulty for post-investment tasks, as the existing IT tools cannot be used in the same way as they have been used by Russian management.

A more specific problem is reporting to the mother company under foreign accounting standards for example IFRS. In an effort to adequately deliver these figures, investors are faced with the problem of finding adequately competent people to develop specific IT tools and connections and accounting management behavior such as early closing or the use of accruals. Even if in big towns like Moscow and St. Petersburg there are now people with experience in this (even if limited in number), in smaller towns, it is nearly impossible to find such persons. This is why many foreign companies ask for help from international accounting firms.

Anyway, in the first period of post-acquisition, companies have to realize that figures from Russia

may not be really reliable and that there are a lot of surprises to follow.

### **Recommendation**

All this post-acquisition or investment problems are difficult to manage for the investor. The most critical thing is to find reliable managers, who can deal with this. Very often, managers at the level of the mother company are not available in sufficient numbers or don't have the required skills starting from knowledge of Russian language. Recruiting managers in Russia is difficult and we recommend strongly that the help of international recruiting firms be sought. It should be advised also that the help of outsourcing firms or professional advisory firms in the different fields of accountancy, financial reporting, technique, distribution or administration should systematically be asked for. The Russian companies are yet to adopt this practice, but this will help and in the long term, be cost saving.

## Now that you've got the Russian financial statements, what are you going to do? Can the Russian financial statements be useful to a foreign investor?

Anton Kalanov, Head of International Accounting Department, Interexpertiza



### Anton Kalanov

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With over 13 years of professional experience, Anton is in charge of international audits, compilations of International Financial Reporting Standards (IFRS) reporting (followed by the Big 4 audit), as well as all other international projects of the company.

Author of around 50 articles and books published in main Russian professional editions on various issues of IFRS, Russian Generally Accepted Accounting Practices (GAAP) and taxation.

Anton is a member of the AEB Audit and Accounting Working Group.

### Introduction

In most cases a foreign investor, first-of-all, is faced with a lack of understandable financial information with respect to Russian companies. It should be considered a success, if on the first stage of negotiations you receive a balance sheet and income statement prepared under the Russian GAAP. But can a foreign user of financial statements make valuable decisions based on these documents? Certainly yes, if you

bear in mind the theoretical and practical differences from western practice, for example from the IFRS.

In this article you will find main differences of the balance sheet (hereinafter – BS) and income statement (IS) compiled under the Russian GAAP (hereinafter – RAS) from analogues compiled under IFRSs.

### Three important points to consider when using this article

1. This article is a tool for those who have to extract useful information from RAS reporting, as well as from any other available source – without relying on any of them in full.
2. This article cannot be used as a comprehensive analysis covering all peculiarities. All usually immaterial and/or rarely appearing RAS-IFRS differences fall out of scope of this publication, though in particular unfortunate circumstances they can become very material.
3. There is no guarantee that the accountant/auditor in your case will act the way an average accountant/auditor is used to acting, in author's experience. Users of financial statements always have to make decisions in the circumstances of chronic lack of full and reliable information and take risks into consideration: this publication can be helpful, but it is not a remedy.

### Main RAS-IFRS adjustments

Fortunately, the BS's and IS's baseline numbers of all the Russian companies are the same. That is

Balance sheet						
ASSETS	Line Number	Relevant IFRS	Relevant RAS	Substance in comparison to IFRS	Amount of necessary adjustments	Note number
<b>I. Non-Current Assets</b>						
Intangible assets	110	IAS 38	RAS 14, RAS 17	Sim	Imm	–
Property, plant and equipment	120	IAS 16	RAS 6	Sim	Attn	S1.
Construction in progress	130	IAS 16	RAS 6	Sim	Ltd	S1.
Property, plant and equipment for rent	135	IAS 16, IAS 17, IAS 40	RAS 6	Attn	Attn	S1.
Non-current financial assets	140	IAS 39	RAS 19	Sim	Attn	S2.
Deferred tax assets	145	IAS 12	RAS 18	Sim	Ltd	–
Other non-current assets	150	IAS 1	RAS 1	Imm	Imm	–

<b>II. Current assets</b>						
Inventories	210	–	–	–	–	–
Materials, supplies and Sim	211	IAS 2	RAS 5	Sim	Sim	S3.
Work in progress	213	IAS 2	RAS 5	Sim	Ltd	S3.
Finished goods and goods for resale	214	IAS 2	RAS 5	Sim	Ltd	S3.
Goods shipped	215	IAS 2	RAS 5	Sim	Ltd	S3.
Deferred expenses	216	–	34n	Imm	Imm	–
VAT on valuables acquired	220	–	–	Sim	Sim	–
Long-term receivables	230	IAS 39	RAS 1	Sim	Ltd	S2.
Trade receivables (long-term)	231	IAS 39	RAS 1, 34n	Sim	Ltd	S2.
Short-term receivables	240	IAS 39	RAS 1	Sim	Ltd	S2.
Trade receivables (short-term)	241	IAS 39	RAS 1, 34n	Sim	Ltd	S2.
Current financial assets	250	IAS 39	RAS 19	Sim	Attn	S2.
Cash	260	–	–	Sim	Sim	–
Other current assets	270	IAS 1	RAS 1	Imm	Imm	–

<b>EQUITY AND LIABILITIES</b>	<b>Line Number</b>	<b>Relevant IFRS</b>	<b>Relevant RAS</b>	<b>Substance in comparison to IFRS</b>	<b>Amount of necessary adjustments</b>	<b>Note number</b>
<b>III. Equity</b>						
Charter capital	410	IAS 1	RAS 1	Sim	Ltd	S4.
Additional paid-in capital	420	IAS 16, IAS 1	RAS 6, RAS 9	Sim	Ltd	S4.
Legal reserves	430	IAS 1	RAS 1	Sim	Sim	–
Retained earnings	470	IAS 1	RAS 1	Sim	x	–
<b>IV. Non-current liabilities</b>						
Loans and borrowings (long-term)	510	IAS 39, IAS 23	RAS 15	Sim	Ltd	S5.
Deferred tax liabilities	515	IAS 12	RAS 18	Sim	Ltd	–
Other long-term liabilities	520	IAS 1	RAS 1	Imm	Imm	S5.
<b>V. Current liabilities</b>						
Loans and borrowings (short-term)	610	IAS 39, IAS 23	RAS 15	Sim	Ltd	S5.
Accounts payable	620	–	–	–	–	–
Trade payables	621	IAS 39	RAS 1	Sim	Ltd	S5.
Payables to employees	622	IAS 19	RAS 1	Sim	Ltd	S5.
Payable to state funds	623	IAS 1	RAS 1	Sim	Ltd	S5.
Taxes payable	624	IAS 1	RAS 1	Sim	Ltd	S5.
Other payables	625	IAS 1	RAS 1	Sim	Ltd	S5.
Payables to shareholders	630	IAS 10	RAS 7	Sim	Ltd	S5.
Deferred revenue	640	IAS 20	RAS 13	Ltd	Ltd	–
Provisions	650	IAS 37	RAS 8, 34n	Ltd	Imm	–

<b>Income statement</b>						
	<b>Line Number</b>	<b>Relevant IFRS</b>	<b>Relevant RAS</b>	<b>Substance in comparison to IFRS*</b>	<b>Amount of necessary adjustments*</b>	<b>Note number</b>
Revenue	010	IAS 18, IAS 11, IAS 1	RAS 9, RAS 2	Sim	Ltd	S6.
Cost of goods sold	020	IAS 1, Framework	RAS 10	Sim	Ltd	S7.
Commercial expenses	030	IAS 1, Framework	RAS 10	Sim	Imm	S7.



Administrative expenses	040	IAS 1, Framework	RAS 10	Sim	Ltd	S7.
Interest gains	060	IAS 39	RAS 9	Sim	Sim	S2.
Interest expenses	070	IAS 39, IAS 23, IAS 37	RAS 10, RAS 15	Sim	Ltd	S5.
Gains from investments in other companies	080	IAS 18, IAS 28	RAS 9	Sim	Imm	–
Other operating income	090	IAS 18, Framework	RAS 9	Attn	Attn	S8.
Other operating expenses	100	IAS 1, Framework	RAS 10	Attn	Attn	S8.
Deferred income tax asset	141	IAS 12	RAS 18	Sim	Ltd	–
Deferred income tax liability	142	IAS 12	RAS 18	Sim	Ltd	–
Current income tax expense	150	IAS 12	RAS 18	Sim	Sim	–

#### \* Categories:

Imm	Amounts in this line item are usually immaterial: so possible RAS-IFRS differences (if any) usually may not significantly affect the financial position and results. If financial statements of a reviewed company have material amounts in such line item then information needs to be requested as maybe material adjustments will be required
Sim	Similar regulations and practice in all material respects: RAS-IFRS differences may be material only in rare circumstances
Attn	Attention: RAS-IFRS differences appear frequently in this line item and their amount is usually material
Ltd	Limited differences: RAS-IFRS differences are not pervasive and may be material only in several limited predictable situations

why one can rely on the tables below, without paying attention to possible differences in translation, whatever they may be. Unfortunately, for statistical purposes, starting from 2011, the year-end baseline reporting numbers have changed and they will probably not be used in reporting to third parties at all.

Below are comments to main required RAS-IFRS adjustments sorted by the relevant accounting Sector (S1, S2 etc).

### S1. Property, plant and equipment [BS.120] [BS.130] [BS.135]

In general, substance amounts and recognition principles are close to IFRSs: both in RAS requirements and RAS implementation practice. But there are some legislation requirements, practical approaches and historical consequences that usually require significant adjustments to property, plant and equipment (hereinafter – PPE) (if these assets are material to the company) during first transition to IFRS:

a) **[Source: practice; Frequency: 95%]** Russian accountants tend to use PPE **useful lives norms** established by government for income tax purposes. These useful lives may or may not approximate useful lives based solely on economical factors. Usually, they are close, of course; but, if PPE are material, then a useful lives change of 15% would affect the financial position greatly.

b) **[Source: legislation]** Unlike IFRS, if the **useful life** of a PPE after initial recognition appears to be obviously wrong, it has to be used till the derecognition of the asset.

c) **[Source: legislation]** It should also be noted that very seldom, Russian companies use a **revaluation model** for PPE: some assets (e.g. real estate) may be restated to replacement cost yearly. The problem is that replacement cost (used in RAS) does not necessary equal fair value (used in IFRS) or, should we say, is always different – fair value is more likely to take into consideration market conditions for resources that are derived from the use of an asset.

d) **[Source: legislation]** RAS does not require and does not allow (unless under a revaluation model) for the recognition of an **impairment with respect to PPE**, even if the market conditions will never allow to recover the carrying amount of PPE.

e) **[Source: legislation]** A Soviet inheritance usually also makes financial statements misleading. **Old assets** may be fully depreciated though still in use, their useful lives were assessed by old legislation, their costs do not include the hyperinflation effect that had to be recognized until 2003 etc. The older the assets the higher the necessary adjustment; usually, a material increase in

fixed assets and in equity is recognized during the first application of the IFRSs.

- f) **[Source: practice; Frequency: 85%]** The line Construction in progress [BS. 130] is used mainly to present PPE not ready for use and, in practice, also often assets that are **not yet brought into use**. Therefore, a carrying amount of some assets that would already be depreciated under the IFRS, remains unchanged. Usually, the effect of this is not material though. It should also be noted that in practice, the majority of accountants do not present **advances given** to purchase fixed assets within non-current assets (instead, within current receivables).
- g) See also the impact of **lease accounting** – [Risk E.].

As a result of possible adjustments, information on PPE in RAS reporting of many companies (and, therefore, EBIT and equity) is not reliable for an investor. But this is not only a RAS problem: both RAS and IFRS do not allow a company to show an increase in value of its fixed assets, unless a company applies the revaluation model accounting policy.

Therefore, investors usually do not totally rely on a carrying amount of PPE in financial statements, except for situations when fixed assets of the company are obviously immaterial or when a quick decision has to be taken. They usually attract appraisers, or take a breakdown of such assets (available only from the company), or have other additional sources of information that enable them get an understanding of the fair value of assets. Otherwise, thorough calculations with an access to extensive internal information of the entity are required.

## **S2. Financial assets and other receivables [BS.140] [BS.250] [IS.060] [BS.230 & 231] [BS.240 & 241]**

Lines [BS.231] and [BS.241] represent receivables due from customers and the difference between these lines and [BS.230] and [BS.240] represent other receivables, advances given, overpayment of taxes etc. Line BS.250 usually presents loans issued (often to related parties). All contents of the line items BS.140 must be interesting to a user of financial statements as equity instruments are presented here.

Material differences are limited:

- a) **[Source: legislation] Discounting** is not applied in Russian GAAP – all amounts are recognized in nominal amounts. Imputed interests for loans with a rate that differs from the market rate are not recognized. [The effect may be significant if the term is material – the rates are high]

- b) **[Source: practice/legislation; Frequency: 75%] Impairment** of financial assets and other receivables in practice is often not recognized until they need to be written-off. Legislation requirements for impairment calculation are also different from IFRS: no discounting, more formal criteria for a triggering event etc. See also S6. and S1. f).

When financial assets are material, investors should ask for additional information from the company. For example, you can ask for description of certain financial assets (substance and rates) and for maturity analysis (ageing). This information would enable an estimation of the adjustments above and would, at the same time, allow an assessment of the level of management.

## **S3. Inventories**

### **[BS.211 – BS.215]**

Important differences are limited:

- a) **[Source: practice/legislation; Frequency: 90%]** In spite of the RAS 5 requirements, the allowance for the **impairment** of inventories is usually not recognized. And, even if recognized, costs to sell are never deducted when the carrying amount of inventories is reduced to their net realizable value.
- b) **[Source: legislation permit]** In some **production companies**, all overhead (including management) expenses are recognized in the cost of goods produced while in accordance with IFRS expenses, other than production, are recognized in profit or loss. The necessity to adjust can be seen from the income statement: see if the line [IS.040] is filled in or not.

Fortunately, these adjustments, in practice, are usually not material or material only for a balance sheet, but not for the income statement.

See also S6. and S1.

## **S4. Capital**

### **[BS.410] [BS.420]**

The amount of charter capital in [BS.410] presents the total amount of contributions – not only paid as under the IFRSs. The amounts still due from shareholders, in practice, are often presented within other receivables of [BS.240].

The line item [BS.420] shows the amount of revaluation surplus accumulated [S1. c)] and/or results of positive transactions with shareholders (e.g. share premiums).

**S5. Financial and other liabilities****[BS.510] [BS.610] [IS.070] [BS.520] [BS.621-630]**

Important differences are limited:

- a) **[Source: practice/legislation]** Similar adjustments regarding **discounting** and **maturity analysis** (see S2.).
- b) **[Source: legislation]** Since 2010, small entities received an option to recognize all **borrowing costs** in income statement. Other companies continue to recognize borrowing costs within cost of qualifying assets.

**S7. Revenue****[IS.010]**

Important differences are limited:

- a) **[Source: legislation]** One of the **sale of goods** recognition criteria is the transfer of title and not transfer of control like in IFRS.
- b) **[Source: legislation/practice; Frequency: 85%]** **Revenue from services** (in practice – also still with respect to construction contracts) is usually recognized upon contract (contract stage) completion and not by reference to the percentage of completion like in IFRS.
- c) **[Source: legislation]** Starting from 2010, **small entities** received an option to account for revenue on a cash basis.
- d) **[Source: practice]** Accountants shall most likely account for operations in accordance with **form rather than substance**. For example, media-press companies usually allow customers to return all or part of unsold printed products. In practice, provisions for such returns as a reduction of revenue are not recorded – instead companies recognize revenue and a purchase separately.
- e) **[Source: practice; Frequency: 85%]** Various payments made **in favor of retail chains** are usually recognized by vendors in IS.100 or IS.030 (not as a reduction from revenue) after the corresponding documents have been signed – unless these rebates are explicitly named “discounts” in these documents. The same analogue applies to corresponding gains of retail chains and to cost of inventories they purchase [The majority of payments to retail chains substantiate rebates and should decrease revenue: but the amount, unless disclosed, may be known only from the company].

To anticipate the problems above, one needs to know a common practice in the certain industry. Nevertheless, only a detailed analysis of operations may help to calculate the adjustment and the outcome is unpredictable.

**S6. Expenses****[IS.020] [IS.030] [IS.040]**

Important differences that need to be taken into consideration were described under S1., S3., S6. and S8.

**S8. Other income and losses****[IS.090] [IS.100]**

If the appendix to income statement and notes do not give the necessary information, then it is reasonable to request for a breakdown of these items. Useful information may be found here:

- a) It is possible to find out if a company recognizes allowance for inventories and bad debt provisions or not – and to compare amounts with those deemed necessary in a usual situation in this industry [S2. b), S3. a)];
- b) Some ordinary expenses, sometimes very significant, can be found here and these amounts may be used for necessary reclassification to [IS.020] or [IS.040], e.g. bank charges, property tax, social expenses, various non-income-tax-deductible expenses etc;
- c) Do not get misled by huge amounts of income/losses from sale of PPE and other assets – these are often in practice, presented in gross amount (separately gains, VAT, carrying amount of sold asset etc);
- d) Different non-recurring and special-purpose transactions that might be important for understanding the entity and its performance may also be presented using these line items.

**Higher risk group**

As you can see from above, the number of material differences between RAS & IFRS is limited and usually RAS reporting may provide helpful information. But, there are still situations when Russian financial statements could be totally useless or even misleading:

**Risk A.** When the financial position of a company is formed primarily by items marked by “**Attention**” in the table above. For example, if:

- PPE are most material and are presented primarily by old assets or are primarily leased [see note S1.];
- The company is primarily engaged in investment activity and/or trade of financial instruments [see note S2.].

**Risk B.** When a company’s operating, investing or financing activity is **heavily integrated in some group**, i.e. when the main part of purchases and/or

sales is conducted with related parties, and if the relations are not on an arm length basis. This **cannot be seen** from reporting and can only be revealed by communication and/or due diligence review.

In such cases, consolidated (combined) financial statements have to be prepared. If the company prepares them by itself, the user needs to make sure the consolidation methodology was correct (intergroup operations and balances were eliminated, consolidation perimeter is reasonable etc.).

**Risk C.** If a company uses the **simplified regime** of taxation and accounting financial statements are most probably materially misstated. Possible indicators: low revenue (to fit in the regime threshold), absence of current and deferred income taxes, absence or small amount of PPE (as CAPEX are expensed).

**Risk D.** During crisis periods and in industries most **suffering from crisis**. In such circumstances the habit of many accountants not to recognize impairment of receivables and inventories [S2., S3.] as well as an absence of Russian GAAP requirements to assess and recognize impairment of fixed assets [S1.] may greatly impact the balance sheet and financial performance of a certain company.

**Risk E.** If a company has activities primarily in some industries in particular:

- **Agriculture.** In IFRS biological assets are presented at fair value, in RAS – at historical cost.
- **Lease.** Lease is classified as operating (off-balance for a lessee) or finance (off-balance for a lessor) exclusively by decision of parties stated in the lease contract and not by economic substance of the transaction. Moreover, accounting for finance lease has a lot of differences from IFRS requirements for both parties (e.g. lease payments are not discounted and lessor's profit is amortized through deferred revenue [BS.640]). For justice's sake, the author has seen a leasing company – only once – which managed to make RAS and IFRS reporting virtually identical, but this was made possible only due to peculiarities of the lease contracts.
- **Financial services.** See Risk A. for more details.
- **Construction.** See S6. b) for more details.

**Risk F.** Some Russian companies still have so-called “**managerial accounting**” by which they mean financial results cleared from effect of different tax-avoidance schemes. Only analytical procedures (comparison to other companies in the industry) and communication may help reveal if a certain

company has something to hide. Impact may be small (easy to adjust in financial statements), for example, when a company only shows additional expenses (e.g. consulting) to pay salary or bribes. Impact may be pervasive (difficult or impossible to adjust in financial statements), for example, when a company does not declare a part of revenue, uses undeclared cash for reinvesting, inserts additional special-purpose companies between customers and/or suppliers etc – especially because such transactions often do not leave any auditable trace.

The problem is that an access to “managerial accounting” figures often does not ease the situation of an investor – this picture is drawn up in the way different from financial reporting. Usually it is a cash-based (not accrual) accounting, CAPEX are treated as current expenses, income statements figures are presented with VAT, balance sheet is often not prepared at all, the risks are difficult to calculate. Fortunately, such companies are decreasing in number every year, especially, if a company plans to attract a foreign investor.

In all such higher risk situations, it is important (while in other cases – preferable) to insist on the preparation of IFRS financial statements: otherwise the risk to make a wrong decision greatly increases. The cost of transformation is affordable and usually will be between EUR 5,000 and 20,000 (without an audit as an incompatible assignment). When hiring a consultant for this purpose, it is extremely important to state all deviations from full IFRS requirements that are acceptable for your particular case. What do you need and what can you do without? For example, preparation of BS and IS without detailed notes would cost approximately 45% less, income statement preparation without comparatives – 30% less and so on. Your proposal of a materiality level to be used can also significantly decrease the cost of the assignment. It is also reasonable to require that the team involved in the transformation should be fluent in English to be able to fully understand and satisfy the needs of the foreign investor.

And if the company flatly declines to transfer to IFRS then all a foreign investor has to do is to use Russian folklore against the Russian partners: lessons from a tale about the soldier's porridge from an axe would be very useful here. Make only several requests based on the weak points described in this publication and effectively obtain the whole picture you need.



## Product liability and consumer protection claims under Russian law

Falk Tischendorf, Partner, Beiten Burkhardt



### Falk Tischendorf

Falk Tischendorf is an Equity Partner and the Head of BEITEN BURKHARDT's Moscow office.

After graduating from the Law Faculty of Hamburg University in December 1999 and completing a two year traineeship at the Higher Regional

Court of Dusseldorf, Mr. Tischendorf was admitted to the bar in Hamburg in September 2002.

Mr. Tischendorf started his career as an attorney with Haarmann Hemmelrath & Partner and later worked with CMS Hasche Sigle as a partner and the head of the Commercial and Real Estate practice in Moscow. In March 2008, Mr. Tischendorf joined BEITEN BURKHARDT as the head of the Commercial and Real Estate practice. In January 2009, Mr. Tischendorf became the Managing Partner of BEITEN BURKHARDT's Moscow office.

Mr. Tischendorf specializes in commercial and contract law, real estate law and structuring real estate investments as well as public procurement law and is ranked in Who's Who Legal in the fields of real estate and construction in 2010 for the Russian Federation. Mr. Tischendorf is registered with the Ministry of Justice of the Russian Federation in the register of lawyers of foreign states carrying out attorney activities in the Russian Federation.

Mr. Tischendorf has authored numerous publications, such as the chapter on the Russian Federation in *Handbuch des Vertriebsrechts* (Martinek/Semler/Habermeier/Flohr, 3. Auflage, 2010), and regularly lectures at conferences in Russia and abroad.

Mr. Tischendorf is fluent in German, Russian and English.

### The outline of the problem

Down to the present day, Russia imports consumer products in great quantities. Even today, many consumers in Russia believe more in the quality of products manufactured in foreign countries than in products manufactured in their own country. However, many foreign investors already produce or assemble their products in the territory of the Russian Federation. Not only foreign and local manufacturers, but also importers and sellers have to ask themselves how the Russian product liability and consumer protection system works.

What happens if a product liability case comes up in Russia? Who bears responsibility in such cases? Who has the burden of proving defects and damages? Are there any obligations to recall products? What are the differences between tort and contractual liability? Are there any possibilities of direct liability of the general manager or a foreign shareholder?

The quality consciousness of Russian consumers has increased enormously over the last two decades. Statistics show that consumers in Russia are claiming their rights more and more. Without a doubt, this field of law is designed to protect the legitimate rights of all consumers. However, in practice, especially in several court hearings, we have learned that product liability and consumer protection cases in Russia are often used to test a foreign manufacturer's ability to fulfill unjustified claims.

Even in cases where, based on the merits of the individual situation, a claim had to be admitted, very often, the amount of the claim was completely unjustified. This practice arises mainly due to the customer's ability to file an action without any obligation to pay filing fees. Moreover, even if the court dismisses the claim all costs arising in regard to the claim, including consultancy fees, will be compensated. Therefore, there is no financial risk for any consumer to file a product liability and consumer protection claim. On the one hand, this regulation clearly gives all consumers the possibility to claim their rights, irrespective of their financial state, but on the other hand, some consumers and their representatives use this legal situation to claim unjustified amounts and to put manufacturers under pressure.

There are two other factors that facilitate pressure being put on manufacturers: firstly, in general, no company is interested in getting product liability issues published. And, secondly, all product liability cases are subject to the so called "courts of ordinary jurisdiction". These courts are used to dealing with cases like labor and tenancy law disputes, but not with commercial issues, especially not such difficult hearings of evidence as those usually involved in a product liability case. Moreover, the ruling of a court of first instance will be made by one judge only, and without any consideration of the value of the claim. In other words: you may face a situation in court, where a decision about a USD 150 million claim will be taken by one judge, who usually deals with labor law issues. Please be prepared!

Taking these circumstances into account, and knowing that less than ten percent of all decisions taken by courts of first instance are dismissed or overruled by the courts of second instance, it becomes apparent how important it is to learn about Russian product liability and consumer protection law.

## The applicable law

For foreign, especially European manufacturers, importers and sellers it is very important to know Russian substantive law, because both Russian law and Art. 5 of the New Regulation (EC) No.864/2007 on the law applicable to non-contractual obligations (Rome II) state that in product liability cases, the law applicable to a non-contractual obligation arising out of damage caused by a product shall be the law of the country in which the person sustaining the damage was resident when the damage occurred.

Russian product liability law is primarily regulated by Federal Law No. 2300-1 “On Consumer rights and protection” (**Consumer Protection Law**) and Chapter 59 of the Civil Code of the Russian Federation, where articles 1095 – 1099 (Chapter 59, §3 of the Civil Code) are *lex specialis* to articles 1064 – 1083 (Chapter 59, §2 of the Civil Code), which regulate the general provisions on compensation of damages, and to articles 1084 – 1094 (Chapter 59, §2 of the Civil Code), which regulate compensation of damage caused to the life or health of a citizen. The special conditions on product liability claims are regulated, for instance, by Art. 14 of the Consumer Protection Law.

In this context, it has to be mentioned that the Consumer Protection Law came into force before the second part of the Civil Code and the aforementioned articles. The Consumer Protection Law was drafted and passed in a great hurry, due to the pressure of the special social requirements in the beginning of the 90’s in Russia. While during “Soviet times” the market was straightforward, the political and economic change also resulted in the opening up of the local market and an increase in imported products, often of cheap quality. Against this background, it was necessary to pass a law to protect the rights of consumers on the Russian market. Since then, the Consumer Protection Law has been amended several times.

## Conditions of entitlement

According to Consumer Protection Law there are four general categories of product liability: (1) liability of a manufacturer or seller for inadequate in-

formation on products and services; (2) liability of a manufacturer, seller or importer for violation of a consumer’s rights; (3) liability for damage caused by the supply of defective products or services; and (4) liability for moral damage and suffering caused by the product.

## Strict liability in tort and fault-based liability

Unlike contractual claims, in accordance with article 1064 of the Civil Code tort actions can be filed by anyone, provided the following general requirements are fulfilled: (1) unlawful act/omission by breach of a duty by the defendant; (2) infringement of a protected right (occurrence of damage, including physical or emotional harm); (3) causation between the unlawful act and the occurrence of damage and (4) fault of the defendant.

However, beside this fault-based liability, Russian law also recognizes liability regardless of negligence or fault (“strict liability in tort”). In accordance with article 1095 ff of the Civil Code and article 14 and 7 of the Consumer Protection Law, in product liability cases strict liability in tort arises if products or services obtained by a customer or on its behalf have caused damage to health, life or property as a result of (1) defective design; (2) defective manufacture or recipe failures; (3) unreliable or inadequate information.

## Standing to sue and standing to be sued

In the above mentioned cases, a consumer may file a claim, at his own discretion, against the manufacturer, the importer or the seller, irrespective of whether or not the consumer has a contract with these parties. But which type of consumer is entitled to claim his right (standing to sue)? In accordance with article 1095 of the Civil Code all individuals and legal entities are entitled to file a product liability claim. Under the Consumer Protection Law only individuals are entitled to file a claim. However, the aforementioned rules and law only apply in cases when the products, works or services are acquired for consumer purposes and not for entrepreneurial activity.

Also, what type of person can be sued (standing to be sued)? In accordance with article 1095 ff of the Civil Code, opponents can be a manufacturer, seller, contractor or service provider. These groups of persons are not defined in this chapter of the Civil Code. Article 1096 of the Civil Code states only that the manufacturer or the seller can be made to pro-

vide compensation at the choice of the claimant. In accordance with the relevant case law, a claim might also be brought up against a manufacturer of a component or product module. There are definitions in the preamble of the Consumer Protection Law of the terms “manufacturer”, “performer”, “seller”, “distribution partner” and “importer” as possible opponents for consumer protection claims. It has to be mentioned that the provisions of the Consumer Protection Law do not apply to legal entities, and there is no room for any analogy in accordance with article 6 of the Civil Code. Finally, the question must be asked if it is possible to file a claim against a so called quasi-manufacturer. This type of manufacturer includes legal entities in the commercial chain of distribution having some kind of responsibility for manufacturing a defective product. There is no legal definition in either the Consumer Protection Law or in Chapter 59 of the Civil Code regarding this type of manufacturer, but in chapter 54 (franchise) the legislator included a norm that regulates the liability of a franchisor as a quasi-manufacturer, and under article 1034 of the Civil Code a franchiser bears subsidiary liability for claims made against the franchisee on the nonconformity of the quality of products sold by the franchisee. The franchisor shall be liable for claims made against the franchisee as the producer of products of the franchisor.

### **Products, work, services and defective design, defective manufacture, recipe failures, unreliable or inadequate information, failure, development risks, development failure**

In general, a product liability claim may be filed in regard to any products sold on the market. The term “product” also includes raw materials, intermediate products, adhesives, elements, sub-products, modules and components. Moreover design risks are covered.

As mentioned above, there have to be certain conditions of entitlement such as defective design or defective manufacture or recipe failures or unreliable or inadequate information that lead to an infringement of a protected right. Having said this: when do we have such defects? Neither chapter 59 of the Civil Code nor the Consumer Protection Law define this term, but rather, apply the conditions of the products. The consumer shall have the right to acquire products that are safe under the usual conditions of their use, storage, transportation and utilization. The wording “under usual conditions” is

objective, and does not allow any interpretation in favor of a subjective expectation of a consumer. To prevent your company, as a manufacturer, from any inconveniences, you should explain the usual safety expectations of the product in the instruction or product information handbook. If compulsory provisions have been established in respect of products that require special safety standards, the compliance of these products with these provisions shall be subject to confirmation under a procedure established by law.

### **Infringement on a protected right that leads to damage and causation**

Protected rights are life, health and property. The infringement has to lead to physical or emotional harm, and there has to be a contributing cause between the infringement and the damage. A product defect alone, without any damage, will not lead to a product liability or consumer protection claim.

### **Occurrence of damage within the stated time of permanency or operating time**

Moreover, the occurrence of the damage has to take place within the stated time of permanency or operating time. In cases where such terms are not stated, a statutory term of ten years (beginning with the day of completion of manufacture of the product) applies. Furthermore, it must be taken into account that a claim can be filed in the following three situations, irrespective of any time period: (1) if a time of permanency or operating time was not stated, but was required by law (as, for instance, for food or drugs); (2) if the consumer has not been informed of the actions which he must take after the term of permanency or operating term have expired; and (3) if the consumer has not received all necessary information or has received false information about the product.

### **Evidence in exoneration**

The manufacturer, seller or performer of work and services shall be freed from all product liability if he is able to prove that the damage or harm was the result of a violation of the established terms of use by the customer or the result of force majeure.

## Scope of liability and several liable persons

There are no maximum liability sums regulated by law. The full compensation claim includes the value of the damaged property, repair costs and all other costs needed for the reestablishment of the infringed right, the earnings lost due to the damage, and the compensation for immaterial damage.

There might be situations where several persons are responsible for the occurrence of damage. The Consumer Protection Law does not regulate such situations. As mentioned, the group of persons that might be covered by the term “manufacturer” is not well-defined. However, the Civil Code stipulates that in cases where damage is caused by several persons, these persons are liable as joint tortfeasor. In such cases, the claimant will usually file suit against the most solvent person.

## Conclusion

The Russian product liability and Consumer Protection Law applies to both products produced in and products imported to Russia. Due to the fact that

the applicable laws, as well as provisions and guidance, are very consumer-friendly, and the relevant aspects of procedural law also favor the consumer, it is absolutely essential that you deal with consumers in a reliable and trustful manner, to exclude or at least minimize the risk of a possible infringement and a product liability or consumer protection claim.



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## REGIONAL ASPECTS OF INVESTING IN RUSSIA

### The post-crisis development of Southern Russia

Vasily Vysokov, President and Chairman of the Board of Directors, Center-invest



#### Dr. Vasily Vysokov (PhD)

Dr. Vasily Vysokov (PhD) is the founder, President and Chairman of the Board of Directors of Center-Invest Bank (Rostov-on-Don). With international shareholders and a strong business model, Center-Invest Bank is southern Russia's

largest regional bank ([www.centriinvest.ru](http://www.centriinvest.ru)).

Dr. Vysokov is also the current Vice-President of the Rostov Region Chamber of Industry and Commerce, and Deputy Head of the South Regional Committee of the Association of European Businesses in the Russian Federation.

As President of the Endowment Fund for Education and Science in the Southern Federal District, Dr. Vysokov has helped support talented lecturers and students in southern Russia. He is the author of over 200 books and articles on the challenges of the transition economy, privatization, the post-privatization development of small business in Russia, and the post-crisis development of southern Russia (Investment Appeal of the South of Russia (2006),

[http://www.centriinvest.ru/pdf/CI\\_invest\\_privlek\\_English.pdf](http://www.centriinvest.ru/pdf/CI_invest_privlek_English.pdf); Southern Russia Versus the Global Crisis (2009) [http://www.centriinvest.ru/pdf/vysokov2009\\_allbook.pdf](http://www.centriinvest.ru/pdf/vysokov2009_allbook.pdf).

Dr. Vysokov has won awards in many local and international competitions, including a runners-up award in the "2007 FT Sustainable Banking Awards" held by the Financial Times and the International Finance Corporation.

Once the critical phase of the global crisis had passed, many companies began producing post-crisis development strategies and are now actively looking for new markets, new sectors, and new regions in which to sell their goods and services. Companies working in Russia should always include a regional dimension in their strategies; an awareness of the specific characteristics of a region not only reduces risks, but quite often, also generates additional revenue.

In terms of its size, southern Russia (since the end of 2009, the Southern and North Caucasus Federal Districts) is comparable with the markets of

many European countries: it occupies an area of 0.5 million square kilometres, and 23 million people live and work in the region, equivalent to 16% of the total population of Russia. Southern Russia accounts for 8% of the country's gross regional product, more than 6% of its total industrial output, almost one quarter of its agricultural output, 16% of new housing in Russia, 12% of all Russian investment, and more than 13% of Russian retail sales.

### Climate and Location

Southern Russia's annual average temperature is 5°C higher than that of Moscow, and this is crucial to the region's ability to produce many agricultural crops: sunflowers, high-quality wheat, fruit, and vegetables. The unique combination of natural and climatic factors creates an inimitably diverse landscape: semi-deserts, expanses of steppe, alpine meadows, snow-covered mountain tops, and Black Sea subtropics. Foreign visitors acquainted with these sights wholeheartedly agree that, "The south is not the centre of Russia, it is its pearl!"

Southern Russia is located in the triangle of land between Russia's largest rivers, the Volga and the Don, and the Caucasus Mountains and it borders the Caspian Sea, the Black Sea and the Sea of Azov. Long before our time, the trade routes of various peoples passed through this territory and the region contained what we now call "free trade zones". These days, southern Russia is an intersection for water, air, road, rail, and pipeline transport routes between the Caucasus and central Russia and the Urals and Europe. The region's transport infrastructure is well developed: road and rail density is 3 to 5 times higher than the Russian average, and in recent years extensive work has been carried out on upgrading roads, airports, stations, and river and sea ports.

### The population and the economy

The multi-ethnic population that we see today in southern Russia has emerged over the centuries, influenced by the region's location at the intersection of trade routes. This multiethnicity is reflected not only at an official level, but also in everyday life, with the interweaving of different cultures, customs,

**Table 1. Southern Russia as a % of the Russian Federation, 2010**

	Southern Federal District	North Caucasus Federal District
<b>Territory</b>	2.4	1.0
<b>Population</b>	9.7	6.5
<b>Mineral extraction</b>	1.3	0.3
<b>Manufacturing</b>	6.0	1.8
<b>Production and distribution of electric power, gas and water</b>	6.3	2.6
Agricultural output	20.0	9.1
Construction	9.5	3.2
Freight moved by road	9.4	2.2
Communications services*	6.5	3.2
Net financial result**	3.2	0.5
Retail sales	9.1	4.8
Foreign trade*	3.4	0.4
Investment**	11.4	2.4
Foreign investment *	3.5	0.1
Per capita income*	83.3	82.4
Nominal wages**	74.2	60.2
Unemployment	7.7	17.1

\* 3Q2010, \*\* – November 2010.

and traditions imparting a unique character to local literature, music, painting, and even cooking.

Living at the fringes of great empires, the people of southern Russia became bold, freedom-loving, and independent of spirit.

With their long tradition of trade and enterprise, the people of southern Russia have managed to create a market economy that, according to Jean Lemierre, former president of the European Bank for Reconstruction and Development (EBRD), provides a good model for the development of the Russian economy as a whole. The south does produce oil, gas, and coal, but these sectors do not dominate the regional economy. Southern Russia plays an important role in the production of grain, sunflowers, vegetables, meat, milk, and wool. The following sectors have survived and are flourishing in the region: transport, agricultural machine building, ferrous and non-ferrous metallurgy, construction materials production, textile manufacturing, and food production and processing. Southern Russia (the Black Sea Coast and the Caucasus Mineral Waters in particular) continues to be the country's main tourism and recreation destination for the domestic market.

## SMEs

The economy of southern Russia is diversified not only in terms of its sectors, but also in terms of the size of its enterprises: 10% of all Russian SMEs (excluding micro businesses) are based in southern Russia. Although it was these enterprises that “shrank” the most at the start of the crisis, by upgrading their equipment and technology they also began to recover more quickly. It is unsurprising that southern Russia accounts for almost 20% of all investment in Russian SMEs. When visiting areas of southern Russia located far from large towns and cities, foreign partners are pleasantly surprised to see farmers using German technology in their fields, apples being grown using Italian technologies, and companies producing goods that are sold to transnational companies. By using modern equipment and technologies, companies are achieving a three to five-fold increase in production efficiency. SMEs in southern Russia are increasingly being run by young managers who have been educated abroad and who are fluent in European languages.

**Table 2. Indicators characterising the performance of Small and Medium Enterprises (SMEs) – excluding micro businesses, as a % of the Russian Federation**

	Southern Federal District	North Caucasus Federal District
Number of SMEs	8.1	2.6
Number of jobs	9.0	2.7
Investment	17.6	1.6
Sales	7.4	1.9

## Anti-crisis stress test

Not only did the global crisis underline southern Russia's advantages (its climate, geographical location, diversified economy, and entrepreneurial culture), it also demonstrated the sustainability of the region's socioeconomic model in the face of external crises. As personal incomes in the south are lower than the Russian average, the local population could not afford to speculate on the stock market or the property market. Instead, they used savings accumulated before the crisis to purchase goods for which they had longed even before the crisis. With its diversified economy, southern Russia was able to "level out" the slump in production, avoid serious social shocks and unemployment, reduce costs, and adapt production to the new post-crisis environment more quickly. In many sectors in southern Russia the fall in output was less than the average for the same sectors elsewhere in the country. At the same time, by reducing their prices in the early stages of the crisis, southern Russian companies were able to retain their positions in contracting markets and then increase their market shares as these sectors recovered. During the crisis, the general public, the business community, and the authorities in southern Russia all demonstrated a striking level of social responsibility: businesses endeavoured to pay salaries, at the expense of their profits; employees agreed to redundancies and compulsory leave without unnecessary conflict; and the authorities tried to find new jobs for those people made redundant. This crisis was not the first, nor will it be the last; it is just the latest one. The anti-crisis vaccination received by southern Russia and the methods that it mastered during the anti-crisis stress test once again demonstrated the advantages that make it an attractive region.

## The post-crisis development of southern Russia: new challenges and new opportunities

Situational analysis has shown that whatever the developments on global markets, southern Russia adapts quickly. Under all scenarios, southern Russia's sustainable development will continue along its current trajectory:

- a) Economic recovery in developed countries will allow these countries to invest more in modern equipment (fixed assets) and additional demand will be created for the Russian regions that produce energy resources and food products;
- b) Accelerated growth in developing countries will increase demand in these countries for food products;

- c) Fluctuations in market prices for raw materials will only affect the rate of growth in some industries in southern Russia.

At the same time, southern Russia itself will become more attractive for participants in global markets: the region's problems once again highlight its potential for economic growth.

The fact that personal income in southern Russia is 25% less than the average in the Russian Federation indicates potential for improved standards of living and changes in the structure of consumption, the quality of goods and services, and lifestyles. In terms of labour productivity, the efficiency of production, including energy efficiency, and the time taken to implement projects, southern Russia lags three to five times behind European countries. This disparity creates a basis for the formation of a "new industrial space" between European countries and southern Russia.

There are the following opportunities to overcome these disparities:

- a) The post-crisis recovery of the Russian economy by 2013;
- b) The faster pace of economic development in southern Russia, connected with the decision to hold the 2014 Winter Olympics in Sochi (USD10-30bn) and the implementation of projects to develop resorts and recreational facilities in the North Caucasus (USD20bn). As a result, the growth rate of investment in the region will be 15-20% higher than the average rate in Russia, the region will have new infrastructure, and personal incomes will rise;
- c) The unsatisfied demand among the population of southern Russia that became apparent as a result of pre-crisis growth; the emergence of new needs, and the opportunity to satisfy this new demand using earnings from entrepreneurial activities;
- d) The drive demonstrated by southern Russia's entrepreneurs, their recognition of the benefits of new technologies, and their understanding of how to access sources of finance for small projects. The ambitions of the region's politicians and the independence of its entrepreneurs create scope for constructive dialogue between the authorities and the business community, as well as a competitive environment for the introduction of modern equipment and the production of competitive goods on a new technological basis;
- e) There are also additional opportunities to achieve accelerated development in southern Russia by expanding the forms and the spheres of application of the public-private partnership mechanism, drawing on European experience of arrangements such as long-term tariff agree-

ments, purchase guarantees, project co-financing, and equity shares.

### Business and the authorities

The regional political leaders in southern Russia display a healthy level of ambition, as do all southern Russians. There is an unspoken competition among these politicians to achieve the best results for a range of indicators, including: the amount of construction work, investment, the harvest, and repairs to housing and roads. From a roughly equal starting point, each of the Federation members in southern Russia is trying to attract investors by offering more favourable conditions for doing business. Almost every Federation member has created an Investment Promotion Agency, which provides support for large projects involving foreign investors, and these agencies are operating with a fair amount of success. Participants in large projects can obtain tax concessions from the local authorities, and even co-financing for the infrastructure components of projects. A number of the Federation members in southern Russia have designated zones for intensive development, and investment projects in these zones benefit from simplified pro-

cedures for land allocation and the building of infrastructure.

For small projects it is best to find a local partner who knows how to overcome the barriers presented by Russian legislation and its application at the local level. With a local partner, a simple explanation of the content of the project and a public signing of a memorandum of intent is usually sufficient. Although it is not mandatory, the inclusion in agreements of social obligations to support sport, education, and culture is welcomed.

### Business infrastructure

Almost all the large banks, insurance companies, legal and consulting firms, and recruitment agencies, including those founded abroad, have offices in southern Russia, and competition among companies offering business services is strong. Modern business centres, with office premises for rent, have been opened in large towns and cities. The commercial and residential property markets are sufficiently transparent and a wide range of properties is available. Many Russian and foreign investors prefer to set up production facilities in small towns that have railway stations, river ports and access

## At the forefront of sustainable banking in southern Russia



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to federal highways. By purchasing existing enterprises in small towns, investors benefit from simpler land allocation procedures and easier connection to the electricity, gas and water supply networks, but, generally, such a step requires the complete reconstruction of buildings and production facilities.

Chambers of Trade and Industry and various industry-specific business associations are active in all the Federation members of southern Russia. The South Regional Committee of the Association of European Business brings together foreign companies already operating in southern Russia. Members of the committee work together with the authorities, promoting best management practice, including corporate conduct, social responsibility, and public-private partnerships. They also provide advice on an informal basis to anyone wanting to set up a business in southern Russia.

### **The investment potential and modernisation of southern Russia**

Despite inadequate funding for research and development, the number of undergraduate and postgraduate students studying in southern Russia is fairly impressive, and a considerable number of patents are registered. However, when it comes to introducing new equipment and technology for production, southern Russia lags six to seven times behind the average European levels for this indicator. Given this specific configuration of southern Russia's potential for innovation, the optimum strategy for the region's modernisation is for its companies to purchase modern equipment and technology on global markets and to become expert in the efficient production of products, goods, and services that are competitive on global markets.

Southern Russia is increasingly becoming a forum for the reference projects of European equipment suppliers and an area in which they can replicate their experience of modernising different economic sectors. For example, bringing agricultural yields and productivity in southern Russia up to European levels will require an eight to ten-fold qualitative and quantitative improvement in the technology and equipment used by the sector. Bringing the provision and standards of housing up to European levels will require a ten-fold increase in residential construction. Road construction needs to increase by the same amount. According to World Bank calculations, approximately seven billion dollars will be required for the implementation of energy efficiency programmes in the Rostov region alone. Ensuring that SMEs in southern Russia can provide the same level of employment as their counterparts in Europe

will require at least a three-fold increase in the current amount of investment in the sector.

Successful cooperation with European companies to modernize southern Russia requires an integrated approach, including technical, financial and social engineering. By using modern equipment and technologies, as well as trade finance, leasing and factoring, and by introducing best management practice and a system for establishing contractual relationships, southern Russia can "multiply" the effects of investment in the region. Southern Russia has a particularly acute need for European rules of the game in the utilities and communal services market; international financial institutions such as the EBRD, International Finance Corporation (IFC) and Kreditanstalt für Wiederaufbau (KfW) are actively supporting pilot projects in this area.

### **Foreign trade**

As a border region, southern Russia plays a modest role in foreign trade. At the same time, the region accounts for 25 to 30% of Russia's food exports, more than 7% of its textile and footwear exports, and more than 10 to 15% of Russia's imports of metal and minerals. Southern Russia already has the necessary infrastructure to develop its foreign trade: large sea ports, rail services, water transport routes, and regular flights by European airlines. Logistics centres are being built at the intersections of major highways. The customs agencies in southern Russia provide the same range and quality of services as their counterparts in the central region. Today, as much as 65% of Russian grain is exported via ports in southern Russia. However, due to the traditional centralization of foreign trade in the Russian Federation, progress in re-directing trade towards southern Russian channels is slow and requires European companies operating in Russia to adjust their business strategies. For example, following the successful modernization of boiler houses in the city of Taganrog, a European boiler supplier opened a new dealership at the local heating company. All the major car manufacturers and suppliers of general-purpose manufacturing equipment have dealerships in southern Russia. Gradually, dealerships are becoming service centres, capable of assembling components. Many companies are introducing energy-efficient technologies and expanding their imports of energy-efficient equipment.

One of the markets that is doing well in southern Russia post-crisis is the real economy. This sector is demonstrating attractive, sustainable growth, driven by increased efficiency resulting from the modernization of equipment and technology.

## PECULIARITIES OF OPERATIONS OF FOREIGN SMALL AND MEDIUM BUSINESSES ON THE RUSSIAN MARKET

### SMEs investing in Russia: Things you should know

Chetwynd R.F. Bowling, Managing Partner, Alinga Consulting



#### Chetwynd R.F. Bowling

Chet is Managing Partner at Alinga Consulting Group. Chet holds a BA and MA in Law from the Russian People's Friendship University and received his MBA from the Business School of Kingston University in the United Kingdom. As the

Managing Partner and a founder of Alinga Consulting Group in 1999, he has played a leading role in managing the service delivery and consulting major clients. Chet also specializes in taxation of foreign companies doing business in Russia and his experience includes advising a large US industrial gas company on a multi-million dollar equity and debt investment into Russia; providing transaction support to a French food manufacturer acquiring a factory in the south of Russia; providing tax structuring to a UK investor in the Russian agro sector.

Small and Medium Enterprises (SMEs) play major roles in most developed economies. They help bring flexibility and resilience to the economy, especially in times of crisis. They can be an engine of growth as very often it is they, and not the large companies, that find and commercialize the "next big thing." However, the significance of this sector is still not fully recognized in Russia and this is reflected in their level of support in Russia. I once heard a senior government minister say that "Russia will never be a small company economy like Italy. In Russia, we like big companies like Gazprom."

The major value of SMEs, and where Russia could really benefit, is the SME's ability to empower people to make a difference in other people's lives. Allow a person to start his own business, and he can provide for not only himself and his own family, but also create more opportunities for others to provide for themselves and their families.

As way of introduction to what I feel are some of the most important issues for SMEs investing in Russia to consider, I would point out that the general lack of attention and support for SMEs in Russia means that owners or managers of smaller operations are often shocked by the cost of entry into the market –

both in time and money. Start-up, or just general compliance while still at a very low level of activity, is disproportionately burdensome to a small business, prompting outlays of time and money that would be better directed toward business development.

Below, I highlight some of the issues that I consider important. In over 15 years of consulting foreign firms doing business in Russia, these have all either been regular issues addressed at start-up, or as matters of ongoing compliance and financial strategy, or simply conversations with clients and other businesspeople on the challenges of doing business in Russia.

#### **1. The Basics – Setting up a legal presence: Limited Liability Company (LLC); Joint Stock Company (JSC); Rep Office; Branch**

It has certainly become easier to establish a business in Russia. The timeline has shrunk considerably since the late 90s/early 2000s. Registration of a business (for the simplest LLC) used to take about three to five months; now three weeks is usually enough. The time needed to obtain a work permit has also become much shorter (shrinking from six months to two and a half). At the same time, the rules are constantly changing, at times causing delays.

#### **Limited Liability Company (LLC)**

As mentioned, the easiest way to go is to set up an LLC, or OOO as it is known in Russian. Russian law allows for a single shareholder and a single executive – the General Director. Both corporate and individual shareholders are allowed. With the individual shareholder, all that is required is a notarized translation of his/her passport and a visit to the notary and the tax office.

For a corporate shareholder the process is more complicated – the Chief Executive Officer (CEO) of the corporation must sign the application for incorporation. This can be done in the home country and sent to Russia for translation and filing. However, this is not recommended as one small error could result in having to start over, causing significant delays. If possible, the CEO should come to Russia to complete the process. If this is not possible, then a nominee shareholder (this would be the local man-

ager, if he is trusted or one provided by the legal firm handling the registration) is appointed and he will sign all the application documents.

In addition to the above, the corporate documents (charter/by-laws, certificate of incorporation) must be legalized (apostille attached) in the home country and then translated into Russian. Another common delay in the registration process is simply due to unfamiliarity of legal counsel of the parent company with this process of legalization.

### Joint Stock Company (JSC)

The incorporation process of a JSC, known as ZAO by its Russian acronym, is similar to the OOO (see table of comparison below), but has the additional requirement of having its shares registered by the securities commission at incorporation. This legal form is best suited if the company is getting into a joint venture with non-affiliated partners.

### Representative Office and Branch Office

Representative and Branch Offices are not independent legal entities, but rather “sub-divisions” of the parent company. A Rep Office should not engage in commercial activity but a Branch may. In practice, many Rep Offices do carry out all commercial activity without any negative consequences as long as they pay the relevant taxes.

The “accreditation” process as it is called in Russia can take much longer for a Rep/Branch office

compared to a LLC or JSC. This is so because the “accreditation” process (registration with the state) is separate from the tax registration process and as such the whole process can take 6 to 8 weeks.

There are some advantages of doing business via a Rep/Branch office, such as the ease of moving currency out of Russia and obtaining work visas for staff. However, some activities may be limited or more troublesome such as the import of goods or certain licensed activities.

## 2. Funding your operations

Once you have made the decision to set up in Russia some thought should be given to funding your start up and ongoing expenses. There are a few options for financing your operations to consider: share capital; loans; parent-subsidiary financing; cost + arrangements.

The statutory **share capital** for a Russian legal entity is rather small (approx. 220 Euros). There are rumors that this will be significantly increased in the near future and some companies choose to put a lot more funds in at the beginning or after incorporation. This type of funding is not very attractive, as your funds are stuck in Russian rubles with all the related currency risk. Also, having significant cash at the disposal of your local managers provides “opportunity” – one of the prerequisites for fraud.

### Joint Stock Company (JSC)

JSC (ZAO)	LLC (OOO)
The charter capital is divided up into shares (aktsii). This makes it easier to transfer or assign shares as there is a perception of separation of investor from management of the company.	The charter capital is divided up into percentages of membership interest (dol') – i.e., there is an assumption of the member's active involvement in the company's activities.
If a shareholder decides to exit a ZAO then he can do so via the sale of his shares either to the other shareholders or to a third party. The value (selling price) of the shares is determined by the parties and is not linked by law to the net asset value of the company.	If a member decides to exit an OOO he can either sell his membership interest to another member or third party, or he can choose to sell to the company and demand that the company pay him his share of the current net asset value of the company. Such a provision must be set out in the charter of the company.
Share issues must be registered with the Federal Securities Commission (FSC). Additional start-up cost and time.	No need to register with the FSC.
Dividends are paid proportionally to the number of shares owned.	The charter may provide for dividends to be distributed disproportionately from the percentage (%) of membership (ownership).
50% of charter capital must be paid within 3 months of registration and 50% within 1 year. Minimum capital required – 10,000 rub.	50% of charter capital must be paid before registration and 50% within 1 year. Minimum capital required – 10,000 rub.
If the contribution to the charter capital is “in-kind” (property) and not cash, then an independent appraisal is required regardless of the value of such in-kind contributions. Additional cost.	Independent appraisal is not required if the “in-kind” contribution to the charter capital is less than 20,000 rub.
The General Director may be appointed by the Board of Directors.	The General Director may be appointed by the Board of Directors.

### Comparison of Legal, Financing, and Tax Aspects: Russian Legal Entity (RLE) vs. Branch or Rep Office

RLE	Branch/Rep Office (B/R O)
<p><b>Legal</b> A separate legal entity that bears its own liabilities.</p>	Liability is borne by the Head Office
<p><b>Financing and Repatriation of Profits</b> The start-up activities and working capital requirements of the RLE can be financed by the following methods: Charter capital, Loans, Parent (shareholder) financing. Dividends and return of loans can be viewed as forms of repatriation. Service contracts, royalty payments and other similar transactions can also be forms of repatriation. In this arrangement, VAT and income tax withholding, as well as increased foreign currency controls when moving funds out of Russia, are a concern.</p>	There is no tax due on repatriation of profits after tax. Funds are sent to B/RO from the Head Office to finance operations a
<p><b>Accounting Compliance and Tax Filing</b> In general the accounting requirements are bit more burdensome for RLE as quarterly financial statements must be prepared as well as full tax accounting, including VAT.</p>	B/ROs are allowed to file and pay quarterly profit taxes. This is an opportunity for tax planning. No value added tax (VAT) accounting is necessary if there is no commercial activity and VAT is recognized as a cost. It should be noted that if a BO or RO engages in commercial activity then full tax accounting and reporting is mandatory. The accounting requirements are not as burdensome – there are no quarterly financial statements, but an annual report on activities (includes quasi financial statements). Rep Offices which do not carry out commercial activities are exempt from VAT on their rent payments.
<p><b>Foreign employees</b> The RLE would need to apply for permits (for the Company and for the employee) and, in addition, register with the Migration Services to issue work visa support. It should be noted that foreign employees earning more than 2 mil rubles (approx \$66,000) per annum can qualify for a simplified work permit procedure that is valid for 3 years</p>	Current regulations require B/RO to obtain work permits for foreign employees. However in practice this is ignored without serious consequences. If the B/RO deals with government agencies e.g., customs, then the permit should be obtained. The procedure for obtaining work visa support is simpler – i.e., the foreign employee can be in Russia on the proper work visa even if he/she does not have a work permit. The 3-year simplified work permit only applies to Branch offices and not Rep offices.

**A loan** is a popular option because it allows for better cash flow management – cash can be sent in tranches when needed and can be re-paid if there is excess cash in the subsidiary. As such the currency risks and risk of fraud are reduced. In addition, if structured properly, interest on the loans can be charged to profits, reducing your taxes payable.

**Parent-subsidiary financing** is a non-taxable contribution to the capital of the subsidiary by a parent owning more than 51% of the equity of the subsidiary. Apart from the benefit of managing cash flows and currency risks as with loans, this form of financing does not require statutory registration of the increased capital and increases the equity side of the balance sheet. This is also a good solution to improve your net asset position when required by law.

**Cost+** arrangements are becoming more popular as a means of financing a local subsidiary, which is not trading locally. For all intents and purposes, such a subsidiary acts like a rep office but does not have the legal risks accruing to the Head Office. In addition, the “+” aspect is treated as taxable income, therefore, the entity is not loss making and does not

come under undue scrutiny from the tax office. Basically, the subsidiary “charges” the Head Office for all costs (rent, salary, marketing) + a markup based on their internal corporate practice and local market practice (5 to 25%). Taxes are paid to the local budget based on this “profit.”

### 3. Finding a Manager – local or expat?

This issue is crucial to your success (or failure). Many companies enter the market, and based on bad advice, spend a lot of Euros only to fold in 12 to 18 months. Getting good advice and information from your manager on the ground is key. Should you hire a **local (Russian) manager**, with a clear understanding of the local culture and business ethics? In addition, he/she may be well connected, making it easier to solve problems when they arise. The disadvantage of this option is that the talent pool for managers is still relatively small in Russia and even as a SME, you will be competing with the big firms and be expected to pay top dollars to managers.



Presuming that as an SME there is no budget to import a high-level expat, along with family re-location costs, another option is to find **an expat already settled in Russia**, ideally, with a Russian family and looking to stay for a while. These candidates usually speak Russian and have a good understanding of the Russian culture and values. They may have good connections and have worked for startups before, so understand the needs of SMEs on a tight budget. The downside of this group of candidates is that they tend to be entrepreneurial and looking to set up their own business and may not be a long-term solution.

One other option that has become more popular is bringing **a young expat over from the home country**. Usually not married, ambitious, and looking for international experience, they are usually willing to give 2 to 3 years, with relatively low pay to gain this experience. Salary can be relatively low, but given that the personal tax in Russia is only 13%, they have more take-home pay than in Europe. In this case, the employer is expected to provide a flat for the manager, but not the expensive “Pokhovskiy Hills” type.

#### 4. HR issues in Russia

Since the early 2000s, as Russia has become more integrated into the world economy and a younger generation has entered the work force, Russian professionals have become attuned to what “international-standard service” means. It is also generally easier to find staff with foreign language skills in addition to professional qualifications. However, as mentioned before, it is still quite a challenge to find talent.

The recent economic crisis has actually helped SMEs doing business in Russia. For example, the cost of labor and rent – two of the largest costs for a business – have come down significantly. Additionally, Russian employees have slowed or ceased a common pre-crisis practice of asking for a raise only months, or even weeks, after starting – with no basis for the request whatsoever. As the market recovers, that attitude will likely return.

With regard to talent retention and motivation, salary is still the biggest factor. However, job satisfaction and career growth are growing in significance. With regard to additional employee benefits, private medical insurance has become the norm even for SMEs. Meal allowances and compensation for use of mobile telephone are also becoming more popular.

#### 5. Accounting and Taxation

There are several systems of taxation in Russia. The most frequently encountered include the following:

- a) **General system of taxation** – might be applied by all types of legal entities. All taxes and appropriate tax rates (in case of existence of a certain tax base) will be applied.
- b) **Simplified system of taxation** – was implemented specifically for SMEs and can be applied by legal entities where the total annual revenue does not exceed 60 million Rubles (this number is not fixed and may vary from year to year). There are several other limitations including one that says a corporate shareholder cannot own more than 25% of the shares (i.e., a 100% subsidiary of foreign legal entity does not qualify). The tax rate is 6% (if tax basis is revenue) or 15% (if tax basis is profit). Revenue and expenses are to be calculated on a **cash basis**.

Taxes and tax rates applied under the General system of taxation are:

- a) **VAT**. The tax base is the amount of VAT-able sales. General tax rate is 18%; for certain groups of goods – 10%; export operations – 0%.
- b) **Corporate Profit Tax**. The tax base is the difference between income and expense, calculated in accordance with rules of **tax accounting**. Tax rate is 20%.
- c) **Property tax**. Tax base is historical cost of Fixed Assets of the company decreased by the amount of accumulated depreciation, calculated in accordance with rules of **financial accounting**. A fixed asset is an asset which costs more than 20,000 rubles (exclusive of VAT). Tax rate depends on the region of Russia, but cannot exceed 2.2%.
- d) **Personal Income Tax**. The tax base is all forms of compensation (with some exemptions) paid by the employer for the benefit of the employee. This is the employee’s personal obligation; tax rate is a flat 13% for residents and 30% for non-residents.
- e) **Social insurance payments**. The tax base is all forms of compensation (with some exemptions) paid by the employer for the benefit of the employee. This is the employer’s only obligation; the tax rate is 34% for 2011. It should be noted that for foreign employees on a work visa this tax is not levied.

*Submitting tax returns and financial statements.*  
*Local tax authority.*

Every company is obliged to prepare financial statements using its accounting data. Financial

statements shall include a balance sheet, Profit and Loss statement (P&L), related addenda, as well as notes to statements. Financial statements shall be signed by both the chief executive and the accountant of a company. These documents must be approved by the Meeting of Participants in the annual meeting.

Every company shall provide quarterly bookkeeping reporting within 30 days upon the expiration of the quarter and the annual bookkeeping reporting within 90 days upon the expiration of the year.

A financial year for Russian companies must be the calendar year. Interim quarterly statements shall be made containing the progressive total starting from the beginning of the financial year.

All legal entities should also submit tax returns to the local tax authority. All reporting dates for every tax declaration are strictly defined. Companies may submit all documents manually by visiting the tax office, via internet using special software, or simply sending them by post.

In case the company is late and didn't submit even one report on time, the local tax authority has the right to block the company's bank account and to keep it closed until the company submits the report. The bank account may be blocked because of many other reasons such as unpaid taxes, fines, penalties, etc. Very often, outstanding tax obligations exist only in the computer records of tax inspectors and not in reality. This is due to poor administration and low levels of qualification of the staff of tax inspectorates and, as result, they block the company's account without any legal basis. It can take considerable time and energy to settle this problem, so in order to avoid any interruption in the company's activity, we strongly recommend reconciliation of all balances concerning tax obligations with the local tax authority at least once every 6 months.

#### *Financial and tax accounting.*

There is a pronounced difference between financial and tax accounting in Russia. **Financial accounting** includes all information concerning the economic activities of a company and on the basis of this information, a company will prepare financial statements – including P&L, Balance Sheet and Cash Flow Statements.

**Tax accounting** is being used only for calculating Corporate Profit Tax obligations. It should be noted that most Russian accountants focus on tax accounting since this is what the tax office is most interested in. As such, very often the financial statements prepared do not accurately reflect the company's financial standing.

Companies must take into account that financial results (profit) in accordance with financial accounting will differ from the profits calculated in accordance with tax accounting requirements because there are differences between methods of recognizing income and expenses for financial and tax accounting purposes. In other words, some expenses may not be allowed as deductible expenses in tax accounting. The same may be true for recognition of income.

## **6. Closing down your business in Russia**

Before making a commitment to set up in Russia, it is important to understand what it takes to liquidate or officially wind down the legal presence. The words from the song "Hotel California" come to mind when it comes to this issue – "you can check out any time you like, but you can never leave." Before investing in setting up a legal presence, be aware that closing down a legal entity or rep office can take from 6 to 18 months and can be quite expensive. The main problem is reconciling your tax records with the tax office. As mentioned, the tax administration is still poorly run and records are not up-to-date. This can result in repeated visits to the tax office to clarify the status of taxes filed and paid.

Nearly all aspects of start up and ongoing compliance (legal and tax/financial) require either hiring one or more individuals, or outsourcing. Either way, it is a real cost when it comes to Russia and it doesn't wait for your sales to come in. For some businesses, working initially via a distributor or other partners, or simply working directly from the home office for a period – until business revenue can be more clearly projected – may be a sensible first step. For those who are ready and committed to fully entering the Russian market, this overview has hopefully provided some basic guidelines to better prepare you for discussing the process with professional service providers.

## INDUSTRY SPECIFIC ASPECTS OF INVESTING IN RUSSIA

### Transaction based finance products in Russia

Joerg Bongartz, Chairman of the Board, Deutsche Bank



#### Joerg Bongartz

Joerg Bongartz is a Managing Director at Deutsche Bank Global Banking and has been with the bank since 1982. He is Chairman of the Board of Deutsche Bank Ltd., Moscow. Beside this role he is responsible for coverage Financial

Institutions with particular focus on investment banking products. He is also Head of Global Transaction Banking Russia and supervises the firm's activity in Cash Management, Trade Finance, Custody and other Trust and Securities Services. Until May 2006, he was head of Relationship Management for Financial Institutions in Central and Southeast Europe, CIS states and Turkey. In that capacity, he was responsible for the co-ordination and cross selling of all products as well as risk management issues for large commercial banks and central banks in the region. He was also Head of Cash Management Sales Financial Institutions CEE/CIS covering USD and EUR cash products for all FI customers in the region. Before this he was a member of Deutsche Bank's Project and Export Finance Team/Oil and Gas industries and managed a couple of years the bank's offices in Moscow and St. Petersburg.

Joerg Bongartz holds a degree in Business Administration from the University of Hagen

### General

Financing of trade activities collateralized by underlying money flows is a popular product in developed markets. It even became more important in the crisis when access to regular credit and capital markets was closed to many companies.

The main idea behind the financing structure is to lend money as advance for trade receivables against assignment of the latter. The instrument is an ideal source for short-term liquidity and helps companies to exchange commercial loans provided to off-takers into real cash. Under some circumstances Transaction Based Financing can even cover production period, i.e. replace working capital credit facilities.

From corporate finance point of view Transaction Based Finance products make it possible to clean up the balance sheet and improve enterprise value.

On the banks' side the interest for Transaction Based Finance products is based on better risk profile of the instruments because of tied character of the financing and its self-liquidating nature. However, operational expenses could be higher than for regular cash loans.

The most frequently used products are Account Receivables Finance and Supplier Finance.

Account Receivables Finance is offered to sellers in case they have agreed deferred payment terms with their buyers. Supplier Finance is placed on buyer's side to allow smaller suppliers to benefit from the (better) credit rating of their off-taker. Both structures can be arranged on recourse and non-recourse basis depending on risk appetite of involved bank.

### Russian Market Situation

Russian corporates are not as open for modern forms of corporate finance and there is almost no shareholder value culture in place, especially among enterprises below the thin layer of large cap companies. Therefore, Russian corporates prefer to look for more simple financing products like plain vanilla cash loans.

Major demand for Transaction Based Finance comes from local branches of foreign companies. Driving forces are either implementation of globally established balance sheet management procedures or support of their local suppliers by providing credit resources at more attractive pricing.

On the supply side, there is a number of banks and factoring companies offering Transaction Based Finance products. Their capabilities are usually limited by two major factors: risk appetite and refinancing sources. The first factor is a hurdle, especially for international institutions. Some risk mitigation is provided by certain Russian and international insurances, which covers the financial risk of trade transactions. The second factor is mainly relevant to Russian banks and factoring companies.

Since the dilution risk is one of the most crucial aspects of Transaction Based Financing banks and factoring companies prefer to enter deals at a stage

when delivery has taken place already (goods have been accepted by the off-taker) and only the payment risk of the buyer is a subject of the transaction. Financing at earlier stages is seldom.

## Legal Framework

From the legal prospective, the Russian Civil Code provides a regulatory framework for factoring and financing against assignment of sales proceeds (receivables). Financing documentation is usually designed around the two respective articles of the Code.

Cross-border transactions related to export from Russia are limited by Currency Law because prepayment of receivables by an on-shore financing provider is not considered as receipt of export proceeds and causes violation of repatriation rules. To enable Transaction Based Finance the financing institution must be a foreign entity. On the import side, such restrictions do not exist.

Further limitations arise when the price of goods is fixed in foreign currency, but payment should be effected in Rubles. In that case, the financing provider has to make profit-relevant daily adjustments of claim's book value, i.e. is exposed to currency risk. The solution is again to move the financing deal to an off-shore provider. This allows not only to close booking issues, but also to switch all settlements to foreign currency as result of the introduction of a foreign counterpart to the deal. However, the payer's bank needs to be involved at an early stage due to currency control formalities.

## Operational Issues

Knowledge is the main time consumer at deal implementation; this is as a result of the currently low level of understanding of Transaction Based Finance products' driving forces among Russian companies.

What is most crucial, from bank's prospective, is the correct cooperation of the buyer during payment of assigned receivables. Banks expect routing of proceeds to own internal accounts, but cannot control the process of payment initiation on the payer's side. Wrong routing to seller's account implies risk of funds seizure by third parties and increases operational expenses.

## Pricing

There is no general guidance for Transaction Based Finance products pricing levels, because the market is small and highly fragmented. Similar to other

credit products, the first factor for price calculation is funding costs of the financing provider. The ruble refinancing market is very heterogeneous and there is no commonly used benchmark like London Interbank Offered Rate (LIBOR) or Euro Interbank Offered Rate (EURIBOR). International banks usually refer to the Moscow Prime Offered Rates (Mosprime), but it's not a general rule. Besides risk costs, credit margin includes operational expenses, which are usually higher than for regular credit products of same maturity profile. Nevertheless, the interest rate for Transaction Based Finance should be in total, lower than for comparable cash loans.

Russian banks usually provide an all-in rate in order not to disclose refinancing costs, which are very individual.

Pricing of any receivables assignment based financing structure is subject to value added tax (VAT) because such products are not considered as pure banking products that are excluded from VAT. Tax expense can be set off against VAT on the sales side.

Interest rate for Transaction Based Finance can be charged by deduction of a discount from transaction amount or separately. Invoicing is obligatory because of VAT.

## Conclusion

Despite the problems listed above, Transaction Based Finance products form for many Russian corporates an attractive alternative to existing liquidity sources because of lower costs and access to more reputable banks. However, such products are not a universal instrument for any financing need and can be applied only to a specified area of trade transactions.



## Investing in Russian real estate: key issues to consider

Olga Arkhangelskaya, Head of the Real Estate Group in the CIS, Ernst & Young (CIS) B.V.



### Olga Arkhangelskaya

Olga Arkhangelskaya is Partner at Ernst & Young (CIS) B.V. and Head of the company's Real Estate Group in the CIS.

She joined Arthur Andersen in 1997 and Ernst & Young (CIS) B.V. in 2002 and is based in the Moscow office. Olga

specializes in the area of real estate advisory, real estate objects appraisal, feasibility studies, financial analysis, strategy development for real estate portfolios, hospitality market, funds raising and structuring of financial transactions. She has supervised and participated in many significant real estate and appraisal projects; this has included work for major Russian companies (Sberbank, VTB, Russian Railways, Gazprombank), international financial institutions and real estate funds (Eurohypo, CSFB, Aareal, Fleming Family and Partners, Morgan Stanley), Russian developers (Horus Capital, Inteco, Stroyinkom-K, Sistema-Hals, Mirax, Don-Stroy) and international users and investors (Bridgestone, Merloni, Siemens, Komatsu, Mitsui, Daimler).

Olga graduated from the Moscow State University, Department of Computational Mathematics and Cybernetics, where her specialization was in operation research. She holds a degree in mathematics (1991–1996). Other qualifications include a degree in economics (1991–1996), from the Department of Accounting and Audit of the State Financial Academy under the RF Government. She also majored in economics at the New School of Economics. Olga also went to the Professional Appraisal institute, where she specialized as an appraiser. Olga is a member of the Russian Appraisers Society, Certified Commercial Investment Member (CCIM) and MRICS designations, Royal Institution of Chartered Surveyors (RICS) and she is the Chairman of RICS in Russia. She was named 'Personality of the Year' in the real estate market in 2010 at the Commercial Real Estate Awards.

### Key facts

Throughout 2010, the Russian real estate market made good progress in shaking off the after-effects of the crisis. Signs of recovery are most prominent

in the most developed markets: Moscow and St. Petersburg. Regional markets are just starting to follow suit. The most obvious indicators of improving fortunes are vacancy rates, which are decreasing across the Moscow commercial real estate segments, despite new space being added.

These signs of improvement are stimulating inflows of liquidity into real estate projects:

- a) Loan financing resumed to an extent, injecting much-needed cash into the real estate market. Throughout 2010, banks (mostly large government-owned entities) provided financing for a number of development projects. While the majority of money went, as usual, to Moscow projects, some large regional development projects were also provided with liquidity. There was also some evidence of greater interest on the part of foreign banks; Nordea Bank's 100 million USD loan to IMMOFINANZ Group, aimed at refinancing two retail centers in Moscow, may serve as an example. Nevertheless, limited access to financing will remain the principal barrier for many real estate projects.
- b) Investor activity in real estate has been on the rise: total investment in commercial real estate approached USD 3.5–4.0 billion by the end of 2010. If the 4.0 billion mark is confirmed, the increase in investment may reach 17% over the 2009 figures (though still far below the pre-crisis peak of 5 billion USD in 2008). Up to 80% of investment is of domestic origin.
- c) In the first 3 quarters of 2010 – for the first time since the beginning of the crisis – the share of investments in projects under construction exceeded 30%.

Accompanying these developments, Moscow yields decreased over the past year by 200–250 basic points. St. Petersburg submarkets experienced similar dynamics, with resulting capitalization rates 1.5%–2.5% higher than those in Moscow.

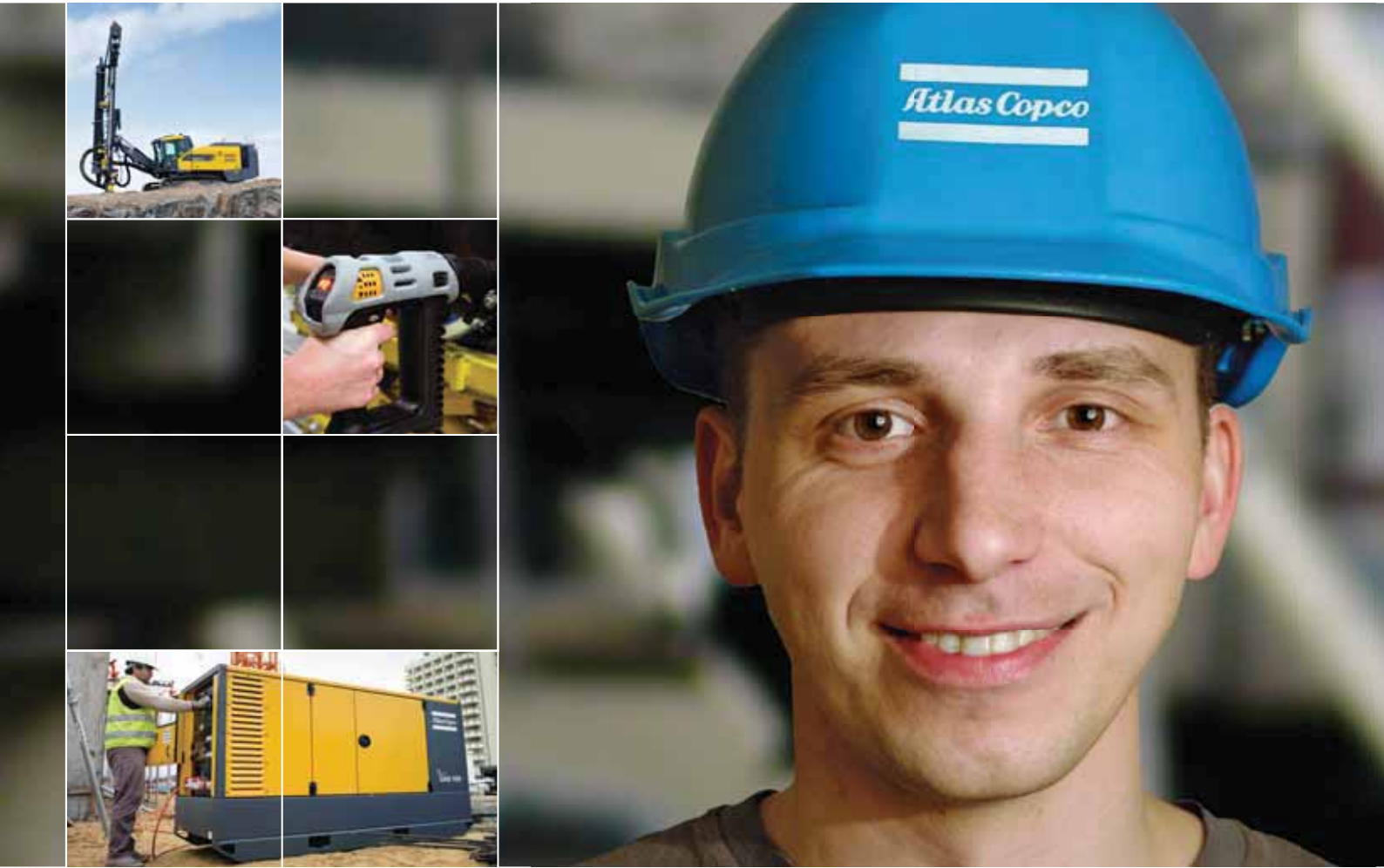
*Source: Jones Lange LaSalle*

### Key recent trends

#### Market sector differentiation

Market sectors are expected to grow at different rates over the next few years. While growth in the office sector may be stunted (due to oversupply in Moscow and an apparent lack of demand for new office buildings in the regions), the retail and ware-

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Sector	2010 Rental rate / ADR change (Q1-Q3)	2010 Vacancy rate change (Q1-Q3)	2010 Supply change (Q1-Q3)	Selected trend
Office	Class A: no change Class B: ▲ 5–6%	▼ 8–10%	▲ 600,000 m <sup>2</sup> ▲ 5–6%	<b>Finished space:</b> leases are being signed for constructed properties only; there is virtually no demand for space under construction.
Retail	(Prof. retail centers) Anchor: no change Gallery: no change	▼ 1–2%	▲ 325,000 m <sup>2</sup> ▲ 8–12%	<b>Quality:</b> Well-designed, well-located retail centers have enjoyed close to 0% vacancy rate throughout the crisis; less successful projects are still struggling to attract tenants.
Warehouse	Class A: no change Class B: no change	▼ 5–6%	▲ 250,000 m <sup>2</sup> ▲ 4–5%	<b>Lack of New Supply:</b> The entire new stock introduced in 2010 is in the range of 50–60% of the stock built in 2009.
Hotel	3*–4*: ▼ 3% 5*: ▼ 1%	▼ 5%	▲ 1,692 rooms ▲ 4%	<b>Operational excellence:</b> Hotels have succeeded in maintaining acceptable yield levels despite declining average daily rates, revealing internal reserves for cost cutting.

Source: open market data, Ernst and Young analysis

house markets are expected to show good dynamics. The future of the hotel sector looks promising as well. Hotels may be buoyed by recovering business travel and several large-scale events to be hosted by Russia in the next 10 years, including the Summer World University Games 2013 in Kazan, the Winter Olympics 2014 in Sochi and the FIFA World Cup 2018. The residential market is also expected to perform well in a recovery.

### Suspended projects restarted

Given no further negative information from the market, owners will restart more projects suspended due to the crisis. This will likely lead to longer absorption times, as new quality projects entering the market will put further pressure on less successful properties. There will be increased differentiation of properties on the market; for quality projects, rents and selling prices are likely to grow at a rate far above the market average.

### Distressed assets

The fundamental issue of distressed assets has not been resolved. So far, owners (and banks that took over collateral properties from former owners as a result of the crisis) have resisted selling at a significant discount. Properties that made it to the market tended to be of questionable quality and were still offered at rather high valuations. Thus, the gap in price expectations between potential buyers/investors and sellers remains a significant obstacle preventing more investors from buying into the market. This issue is unlikely to be resolved easily, since there is no urgency to sell on the part of potential sellers and since selling could seriously undermine their key indicators.

### Change in the Moscow government

The change of administration is a significant event with both short-term and long-term repercussions. This change may lead to greater accountability and improved transparency in the long term, although that is not to be taken as a given. In the short-term, there could be several negative side effects: certain projects that did not go through the full approval cycle under the previous administration may be stalled or tossed out completely. While the government is being formed, approval processes may also be stalled or take more time. Procedures may change as well and developers may experience difficulties as a result, at least temporarily.

### Green development

The idea of green or sustainable projects is gaining recognition and gathering momentum in Russia. The first two "green" projects have already received LEED (Leadership in Energy & Environmental Design) "Gold" and BREEAM (Building Research Establishment Environmental Assessment Method) "Very Good" certification; about ten more are in various stages of the certification process. Considering the increasing focus on green development, it may be worth looking at certification options and also at whether projects to be invested in are green or can be made green at low cost.

### Industrial parks

The issue of industrial parks is being discussed at very high levels of the federal government: it is considered a critical part of the Russian modernization program. Due to the relatively underdeveloped state of this sector, the recently created Association of Industrial Parks is likely to receive government attention and support, which will facilitate further growth.

## Russian real estate: selected tax issues

### Russian taxes at a glance

Tax	Rate
Corporate profits tax (including capital gains)	20%
Dividends received by a Russian entity	9% / 0%
Withholding income tax:	Rate
Dividends paid by a Russian entity to a foreign entity	15% (5-10%)
Interest paid to foreign companies (with certain exceptions)	20% (0-10%)
VAT	18%
Assets (property) tax	Up to 2.2%
Land tax	Up to 1.5%

The main tax rates applicable to the Russian real estate business are shown in the table below.

### Corporate profits tax

- The regional part of profits tax may be reduced, giving a minimum overall rate of 15.5%.
- There are special tax deduction rules and a significant focus on documentation.
- Tax losses may be carried forward for up to 10 years.
- Tax on dividends received by Russian entities may be reduced to 0% if certain conditions are met.
- Withholding tax rates on interest may be reduced under international double tax treaties – to 0% under the majority of such treaties.
- The withholding tax rate on dividends may be reduced under international treaties to 5-10%.
- There are certain limitations on the tax deductibles with respect to interest. These include limitations on the maximum level of tax-deductible interest as well as thin capitalization rules, which limit the deductibility of interest.
- VAT
- Sales of shares, land and residential property as well as certain types of rent are VAT-exempt without credit.
- As a general rule, input VAT incurred as a result of the acquisition or construction of real estate may be offset. Refunds of excess input VAT in cash are legal and encountered in practice.

### Other taxes

- Assets (property) tax is payable based on the Russian statutory book value of any fixed assets, including immovable and movable assets. The tax rate is established by the regional authorities and may not exceed 2.2%.
- Land tax is paid based on the cadastral value of land. The tax rate may not exceed 1.5%.

- Personal income tax is payable by Russian tax residents at a rate of 13% and by non-resident individuals who receive income from Russian sources at a rate of 30% (in certain cases 15%).
- Payments to employees up to a RUR 463,000 cap (per employee) are subject to social fund contributions, with an aggregate rate of 34% (this rate is effective from 2011). Social fund contributions are not assessed on the basis of the remuneration of employees who are neither Russian nationals nor holders of Russian residency permits.

## Recent tax trends and expected changes

### Changes in the Russia-Cyprus Double Tax Treaty

During the last several years, market players have developed a fairly standard approach to structuring investments in Russian real estate. Many investors have used Cyprus as a jurisdiction for holding companies due to the beneficial local tax regime in Cyprus, as well as the favorable Russia-Cyprus double tax treaty. One of the treaty's significant provisions made possible the tax-free sale of companies holding Russian real estate.

In 2010 Russia and Cyprus signed a protocol amending the existing treaty. Among other changes, the protocol allows capital gains from the sale of shares of Russian property companies to be taxed in Russia. Under Russian domestic rules, such capital gains are subject to 20% income tax, and starting in 2015 (when this particular provision comes into effect), this 20% tax will apply to any such gains received by Cypriot holding companies.

This is a fundamental change that has provoked a lot of discussions with respect to alternative jurisdictions among real estate investors. Having said that, similar changes may subsequently be made to double tax treaties with other countries used for real estate investments, such as Netherlands, Luxembourg and others.

### Reduction of the tax cap for interest on foreign-currency loans

A key change for real estate companies involves new rules for determining the maximum amount of interest deductible for profit tax purposes. In particular, tax-deductible interest on loans issued in foreign currency is reduced. Starting in January 2011, this limit is reduced to 0.8 of the Russian Central Bank's refinancing rate (based on the current refinancing rate, only 6.2% p.a. would be tax-deductible).

This change may significantly affect companies which have debt in foreign currency, especially in view of the fairly high average interest rates that



we are seeing in the Russian real estate market. At the moment, companies are considering possible mitigating actions, which may include, for example, switching to ruble loans, using the comparable-loans method to justify higher interest deductions, or appealing to favorable double tax treaties with jurisdictions (for example, the Netherlands) that allow higher deductions of interest.

### **Other significant changes**

Another significant change that may be made in 2011 is the introduction of new transfer pricing rules that are much more sophisticated than those currently in effect. Under the expected new rules, real estate companies may need to prepare formal transfer pricing documentation for certain transactions, potentially including intra-group transactions, with respective interest charges.

### **Selected legal aspects of investing in Russian real estate**

The following is a brief overview of some of the more basic legal issues involved in investing in Russia as well as an update on some of the recent changes in legislation.

#### **Land ownership and rights**

In Russia, unlike some other countries, foreign entities may own (with a few exceptions) and lease land and real property. Land for construction may be acquired from private owners (through sale-purchase or lease) or from the state or municipality (public sale / procedure of granting land with preliminary approval of the property allocation).

Land in Russia is divided into categories: settlement land, industrial land, agricultural land, specially protected natural areas, etc. Within each category of land, the owner may choose its permitted use which describes the exact allowed usage of land in greater detail.

Real property and land are to be registered in the State Cadastre for Immovable Property. Rights to land and real property as well as encumbrances and limitations of rights are to be registered in the State Register of Immovable Property. Rights to real property normally provide the holder with the rights necessary to use the underlying land.

#### **Construction**

The pre-design stage includes decisions on the allocation of the future property and its main characteristics, as approved by the authorities. Key to simplifying this stage are local Rules of Land Use

and Construction, which contain key information on the permitted use of land and key characteristics of the property that can be built on it. The design stage involves the elaboration of design documentation, which for certain types of property requires an approval by a state expert examination. During the construction stage, compliance with state construction rules is monitored.

### **Noteworthy recent changes**

#### **Changes in cadastral valuation legislation**

New legislation on cadastral valuation became valid in September 2010. Among the provisions that will now be enforced, we can highlight the following:

- The cadastral price of land is equal to its market price in cases when the market price of such land is determined.
- Cadastral valuation is to be performed by professional appraisers in accordance with provisions regulating valuation. The appraiser must take out at least 30 million rubles in liability insurance in connection with such valuation.
- A cadastral valuation report is subject to expert examination by a self-regulating organization of appraisers. The results of the cadastral valuation may then be approved by the customer and published.

#### **Changes in legislation concerning construction in Moscow**

The law envisages a number of measures to reduce the total time involved in preparing and issuing documentation for construction in the City of Moscow, including:

- a reduction in the time required for Moscow agencies, institutions and organizations to prepare certain documents
- a reduction in the number of documents that applicants must submit to agencies and institutions – by eliminating the need to submit documents already in possession of other Moscow departments and committees

## Russian real estate investment market: 2010 review

Charles Boudet, Managing Director, Jones Lang LaSalle Russia & CIS



### Charles Boudet

Charles Boudet has been Managing Director of Jones Lang LaSalle Russia & CIS since 2009. Charles joined the company in January 2006 as Associate Director within the Office Agency team. By July 2006 he had become Head of

Office Agency, Russia and CIS, which has shown outstanding results under his leadership. In July 2008, Charles moved to the role of European Director, Russia and CIS, heading both Office and Industrial Agencies. The total volume of office transactions under Charles's coordination exceeds 1,000,000 sq m.

Before joining Jones Lang LaSalle, Charles got a unique experience working as top manager in Russia and Germany. Some of his major roles were coordination of work with corporate clients, coordination of marketing and sales departments and operational activity with 300 employees under management.

Charles graduated from Université Versailles-St Quentin (DEUG A) in 1994. Later, in 1997, he got a degree from Reims Management School (Sup de Co).

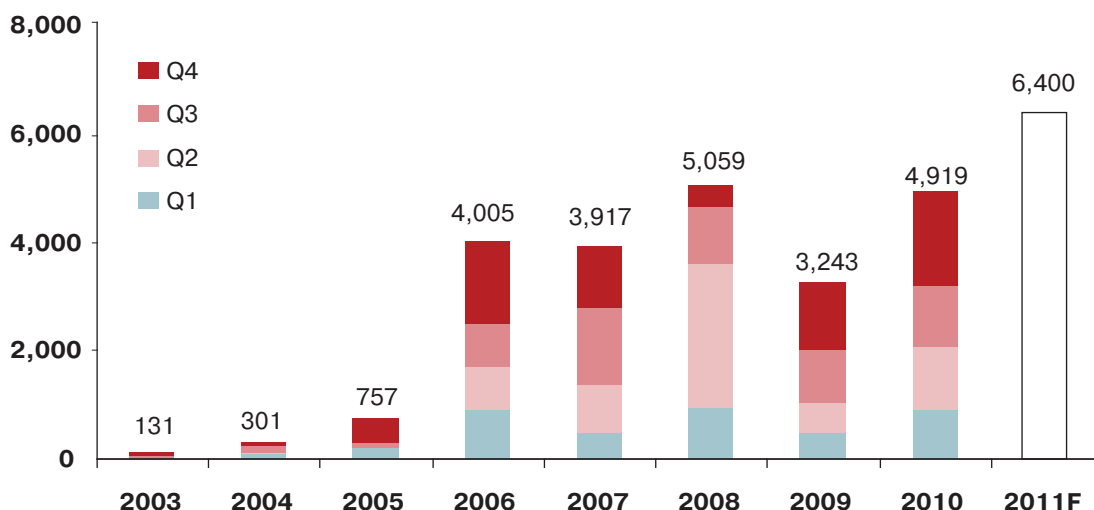
ment market in 2009. Investment activity increased in H2 2010, posting full-year growth of 52%, with a total investment volume of USD4,919 million (23% over our estimate for 2010). Commercial real estate investments increased 24% to USD3,963 million (mln) in 2010 from USD3,193 mln in 2009. We expect a 30% increase in real estate investment volumes, to USD 6.4 billion (bln), of which commercial real estate will amount to about USD 5.2 bln.

Russian-funded investors dominated throughout 2010 (accounting for 79% of the total amount invested in 2010), while foreign investments remained low. However, investor interest from outside Russia increased, with the volume of foreign investment at 21% of the total in 2010 compared with 16% in the previous year. There has been a revival of international real estate investment funds' activities in 2010; the market saw several deals that included an international capital component. Currently, interest from local and foreign investors is in almost equal proportions.

Sector wise, investments were more diversified in 2010 than in 2009. The office segment attracted the bulk of investments, accounting for 46% of all transactions completed in 2010. Residential property was also in high demand, with housing accounting for 19% of the total investment volume in 2010, including several large deals with the participation of the Ministry of Defence. Although developers were focused mainly on the Moscow market (78%), investors started to show more interest in the regions. Deals completed in regional cities in 2010 accoun-

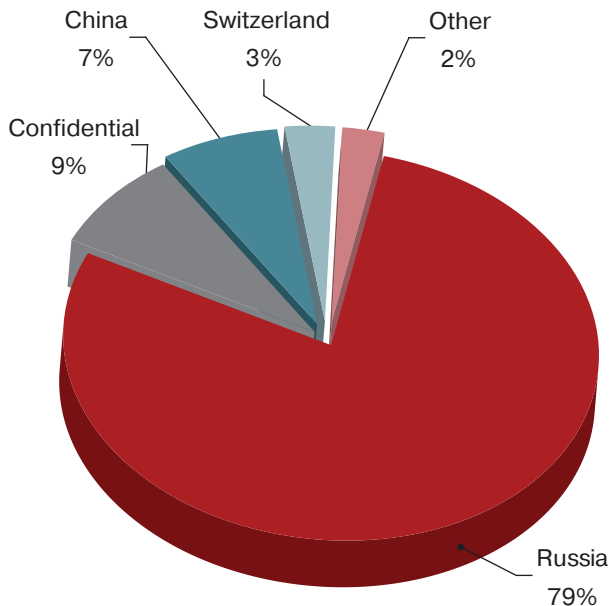
The overall economic stability and improved liquidity in Russia in 2010 led to an increase in investments into real estate, following a slowdown in the invest-

### Investment volume dynamics, USD mn\*

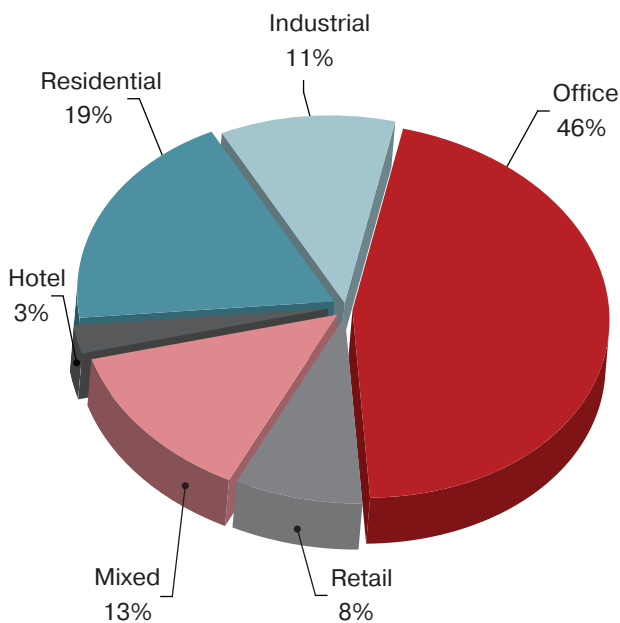


\* Investment deals, excluding corporate acquisitions, land purchases, JVs, direct residential sales to end-users.

**Investment by investor origin, 2010**



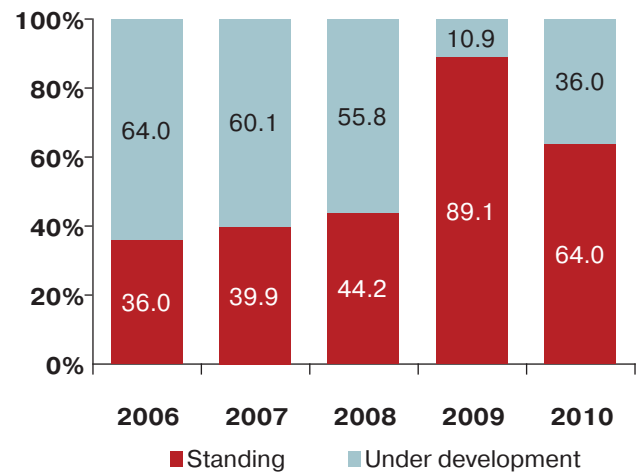
**Investment by sector, 2010**



ted for 22% of the total vs. 18% in 2009. Continued investor interest kept Moscow and St. Petersburg prime real estate yields at virtually Q3 2010 levels. In Q4, Moscow office and shopping centre yields were similar to those in Q3, ending the quarter at 9.5% and 10% respectively. Warehouse yields compressed 50 BPS to 11.5% in Q4. Yields in St. Petersburg remained the same; at 12% for shopping centers, 11.5% for offices, and 13.5% for warehouses.

Investors' interest initially focused on existing projects, which are very rare in the market, as usually prime assets vendors are not ready to sell mainly

**Retail investment breakdown by type**



due to a lack of other interesting investment opportunities for the capital raised to be deployed. Many developers are now returning to their development portfolios which will increase the stock of stabilised assets. However, as a result of compressed yields and rental rate growth, investors have started considering development projects, which accounted for 28% of all deals completed in 2010 vs. 14% in 2009.

In particular, the investor interest in developing properties was more pronounced in retail sector, as only a few existing retail properties are available for sale. Those being offered to the market are not considered reasonably priced, because either the vendor is asking too high a price, or there is too high a debt in place to be incentivizing for vendors, or there is fragmented ownership, which significantly discounts the property value. That is why investors have started to express interest in developing retail assets. In fact, several deals involving under-development projects have been closed recently (Aviapark, Okey in Altufievo in Moscow and the M5 Mall in Ryazan are among the examples), and their share in total retail investment has increased significantly to 36% in 2010 from 11% in the year before (see the chart above). Several deals currently at due diligence stages are at development or re-development stage.

Investors are willing to look at good quality properties or development projects at an advanced stage of construction or planning. With the new mayor being concerned about Moscow traffic, the situation could be complicated for those schemes still waiting for city hall to grant permission for construction. As a result, projects that have already obtained all required permits are in a better position and could get additional interest from investors.

## **Russian real estate investment market: 2011 outlook**

In 2010, on the back of increased senior debt availability on the market, we saw a gradual increase of bank financing to the construction sector. According to the Central Bank of Russia, in 2010 the share of bank financing to the construction sector in the total volume of bank loans increased to 6.5% as at 1 November 2010 from 5.1% as at 1 February 2010. Banks, predominantly state-affiliated, provided debt restructuring or opened lines of credit to developers for high-quality projects, thus supporting construction activities. As a result, many developers recently announced plans to resume projects that have been frozen because of the financial crisis. For example, DON-Stroy Development intends to restart the construction of the Oruzheyniy multifunctional complex in Moscow in early 2011, after it finalises financing from Sberbank.

We believe banks, both international and local, will be more active and financing volumes made available to developers will increase in 2011. Financing has become more available because banks have excessive liquidity and allocations for construction finance are increasing. However, on the back of expected higher interest rates, we anticipate credit financing to become more expensive in 2011. In fact, since year-end 2010 financing has been stabilising, with any decrease in margin matched by increases in interest rates.

Currently, banks prefer to finance residential projects, providing short-term financing, and we are seeing some developers increasing or adding housing components to their office and retail projects. It appears that developers may switch to those sectors, i.e. residential, that are recovering more rapidly from the crisis and from which capital returns quicker. Thus, a number of companies (including AFI Development, Glavstroy, and LSR) are currently changing the concept of their office projects to include residential component. Taking into consideration higher residential real estate prices, Glavstroy and LSR have reduced the size of the office component in some of their St. Petersburg projects. AFI Development announced its plans to build a residential complex instead of a 120,000 square metre (sq m) business park. On the whole, we believe developers' interest in residential real estate will remain high in 2011.

In 2010, the largest Russian banks (Sberbank and VTB) acquired non-core assets in exchange for bad debts and created special structures to manage the assets. Due to the high volume of such as-

sets in banks' portfolios, we expect banks to take a more active role in the management of their non-core assets in 2011.

International investment funds continued to be active on the Russian market in 2010. Recently, the British management company Ashmore Investment Management Ltd. debuted on the Russian real estate market with the purchase of Deutsche Bank's stake in VTBC-DB Real Estate Partners. As the number of announced real estate funds increases and investors continue to consider entering the Russian market, we expect to see in 2011 more deals closed which will include an international capital component.

In 2010, we saw development return to the Russian real estate market after two years of relative inactivity. Many developers have already announced their plans, not only to unfreeze suspended projects, but to launch new ones. A JV, including Atomstroykomplex and the Finnish company SRV, has said it will begin the construction of a multifunctional high-rise project in Yekaterinburg in 2011, which will include a hotel, office and entertainment centre. Additionally, after we saw more regional activity in 2010, we anticipate investor interest in regional assets of different classes and locations to increase in 2011.

There are more foreign buyers in the market, but we also saw Russian equity transactions in the form of investment purchases, and not only for development or owner-occupancy needs. We believe most purchases, especially the opportunistic ones, are based on the view that there currently is a window of opportunity to purchase prime income producing assets in Moscow ahead of substantial rental rate increases and as yields in the Russian market continue to decline to get closer to historical yield gaps in comparison to Central and Western Europe. In the mean time, we expect yields to decrease by 50-75 BPS in all sectors in 2011. The retail sector has been gaining investor attention since the beginning of 2010.



## Sustainable energy in Russia: a pipe dream or an opportunity?

Jeroen Ketting, Director, Lighthouse Group



### Jeroen Ketting

Jeroen Ketting is Founder and Managing Director of Lighthouse. He has been living in Russia for over 15 years, giving him fluency in the Russian language and a thorough understanding of the Russian business culture. Jeroen has

founded and operated numerous businesses in Russia and has assisted in the establishment of more than 20 Western-Russian business ventures. Jeroen's extensive experience in the Russian market is backed by a strong track record in strategic business advisory. He is an expert negotiator and mediator in the Russian-Western context and is a regular speaker at international events and seminars related to Russia. He frequently contributes to Russia related international publications.

Jeroen is the Chairman of the Energy Efficiency committee of the Association of European Businesses in the Russian Federation (AEB Energy Efficiency committee).

A sustainable energy supply is one of the most important challenges we face in the 21<sup>st</sup> century. As is often the case, a challenge also means an opportunity and many small, medium and large sized businesses in many countries are capitalizing on this opportunity. These companies have become players in a steadily growing billion Euro industry, focused at the two pillars of a sustainable energy future: Energy Efficiency and Renewable Energy. The sustainable energy industry in Russia, however, is still in an embryonic state, and the big question is whether it will ever develop in the billion dollar industry we already see outside of Russia.

In 2010, the German market for energy efficiency technologies alone, was estimated to be 67 billion Euros. The investments in renewable energy in Germany in the same year stand at about 25 billion Euros, with most of that money going into biomass, solar energy and wind power projects. Bloomberg New Energy Finance estimates that the world wide annual investment levels in renewable energy will double from 243 billion dollars in 2010 to 500 billion dollars by 2020.

Investment in sustainable energy in Russia pales in comparison to what is happening in the rest of the

world. The Russian Ministry of Energy estimates that until 2020, 80 billion dollars need to be invested in energy efficiency and 300 billion dollars in renewable energy. Considering that in 2009 Russia invested a little more than 2 billion dollars in renewable energy, there is still a long way to go.

After the United States and China, Russia is the biggest energy consumer in the world. If we look at energy intensity (the amount of kilograms of oil equivalent used per dollar of GDP), then Russia is even number one in the world. Not a first place to be proud of. With rising energy tariffs, increasing energy consumption and a stagnating energy supply, one would expect that Russia has a strong interest in catching up with the rest of the world, but not much is happening. The big question is 'why' and what can be done about it.

On one hand, the years 2009 and 2010 have brought about a situation whereby the Russian Government now has energy efficiency and renewable energy high on the political agenda. Increasing energy efficiency and making the transition to a rational resource consumption model is now one of the main economic modernization policies in Russia. After the adoption of the Energy Efficiency Law, further legislation is being drafted and federal and regional target programs are being developed.

On the other hand, there are many barriers that impede a healthy development of the sustainable energy market. First of all the tariffs, although steadily rising, are still three, sometimes four times lower than in most EU countries. All experts agree that for viable energy efficiency and renewable energy projects a considerable rise in tariffs is needed. In addition, one of the main drivers of the sustainable energy market in the West is missing in Russia – subsidies. Most of the biomass, wind and solar projects in the West have in one or another form received government subsidies or tax incentives.

Awareness about sustainable energy is also a cultural issue. In Western countries it is the middle class that has a savings culture and the small and medium sized enterprises are the ones that drive innovation, entrepreneurship and new developments in energy efficiency and renewable energy. In the Western economies more than 90 percent of the population consider themselves to be part of the middle class and small and medium enterprises produce more than 70 percent of the Gross Domestic Product (GDP). The Russian middle class accounts

for maybe 20 percent of the population and small and medium sized enterprises produce at best 16 percent of Russia's GDP. It is no wonder that investments into sustainable energy are accordingly modest.

Another constraint on the growth of Russia's renewable and energy efficiency market is caused by the low share of private investment and venture capital in this sector. These sources of funding are starting to play a big role in the USA, China and the EU. Venture capital investment into renewable energy in these countries equalled 4 billion dollars in 2010, which is two times more than all the renewable energy investments made in Russia in 2009.

Does that mean that investments in sustainable energy in Russia are hopeless and that you can stop reading this article? Not necessarily; there are always opportunities and they will come to those who know how to wait.

Investing in projects in the public sector is still a rather risky affair. Public officials tend to change regularly, procurement needs to be done in accordance with federal legislation (i.e. the lowest bidder wins) and commitment of funds from the state budget is limited to a small number of years, and thus, is likely to change as well. Projects aiming to invest into the residential housing sector are also difficult. All the tenants in a building need to agree with the investments made, and once the investor installs the equipment in the building, ownership issues arise immediately. Renewable energy projects, such as solar energy, wind power and biomass, will not be commercially viable, as long as subsidies and tariffs are not significantly increased. Although potentially, in a single hour, solar energy can supply all the energy consumed worldwide in one year, it will still have to be Research and Development (R&D) budgets and not investment budgets that develop solar energy as the potentially most viable renewable energy source known at this moment.

If you ask me what area of Russia's sustainable energy sector I will most likely put my money in, I'd say that it will have to be innovative products or businesses, where a mass market is involved or those projects where I can implement a sustainable energy project in a fully controlled environment.

Products, services or businesses, where a mass market is involved are those cases when goods or services are sold to a wide public of consumers, industrial clients or commercial clients. Any business dealing with state of the art energy efficient goods and technologies that have a wide market can be interesting. For example, products that can be used in and around the built environment such as insu-

lation materials, energy efficient heating and cooling systems, lighting, intelligent control systems, smart meters and energy efficient appliances. But also technologies that can essentially be used in any industry, such as pumps, electric motors, compressed air systems and measurement and control systems are of interest. Also, consulting services such as advice on energy-efficient methods and production processes belong to this category.

Projects in a controlled environment, for example, are projects on, and within the boundaries, of an industrial (e.g. any production plant) or a commercial site (e.g. logistic or retail centres). Typically, an energy efficiency or renewable energy project includes a performance component. This means that part or all of the return on the amount of money invested in the project depends on the actual financial savings achieved. Examples of this type of projects are replacement of compressors, pumps and heating systems and the installation of combined heat (cooling) and power systems. In these cases, it is crucial that you be able to measure, benchmark and verify all the relevant energy consumed and that is only possible when you have a sufficient level of management control over the actual site of the project. These projects usually have still rather long payback periods, but with the rising energy tariffs they are becoming more interesting as we speak.

Many challenges lie still ahead of us and we can only face these challenges if each of us, living and working in Russia, reflects on our personal responsibility for energy saving, as it is becoming the norm all over the world. In the meanwhile, money can already be made in Russia for those with the right understanding of the market, of the peculiarities of the Russian business environment and with a healthy appetite for adventure.

In the ten years that I have been doing business in energy efficiency in Russia, I have seen many positive changes and I have seen the rate of change accelerate over the years. There is one thing that is clear to me: this is the time to move into the sustainable energy market!

## Foreign investments in strategic sectors in Russia

Alex Stoljarskij, Attorney, Beiten Burkhardt



### Alex Stoljarskij

Alex Stoljarskij 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"<sup>1</sup> ("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"<sup>2</sup> ("**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**"<sup>3</sup> ("**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-**

<sup>1</sup> Federal Law No. 57-FZ dated 29 April 2008

<sup>2</sup> Federal Law No. 160-FZ dated 9 July 1999

<sup>3</sup> 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**

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

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.<sup>4</sup> 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.<sup>5</sup>

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.)

<sup>4</sup> See The St. Petersburg Times, dated 6 April 2010 “Strategic Law Ensnarers Domestic Firms”, [http://www.sptimes.ru/index.php?action\\_id=100&story\\_id=31146](http://www.sptimes.ru/index.php?action_id=100&story_id=31146).

<sup>5</sup> In detail, taking into account effective law and recent court practice, see Stoljarskij/ Samoylov, “Utilization of the Law on Strategic Investments in Corporate Disputes”, Korporativny Jurist No. 10/2010, from page 49 (in Russian).

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 establish-

ment 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 monopolies<sup>6</sup>;
- 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 significance<sup>7</sup> (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"<sup>8</sup>. 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.

<sup>6</sup> Federal Law No. 147-FZ dated 17 August 1995 "On Natural Monopolies".

<sup>7</sup> See the list of subsoil plots of federal importance dated 5 March 2009, in the version dated 13 August 2010.

<sup>8</sup> Law No. 2395-1 dated 21 February 1992.

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?<sup>9</sup>

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 well<sup>10</sup>, 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

<sup>9</sup> The Deputy Head of the FAS, Andrey Tsyganov answers in an interview with Veselova/Stoljarskij, AEB Business Quarterly (Winter 2010/2011) page 7 (12): "In a case like that, a request is sent to the FAS." [http://aebus.ru/application/views/aebus/files/magazines/19.Legal\\_magazinesFile\\_2010\\_12\\_09\\_13\\_11\\_28.pdf](http://aebus.ru/application/views/aebus/files/magazines/19.Legal_magazinesFile_2010_12_09_13_11_28.pdf)

<sup>10</sup> 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 took 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<sup>11</sup>.

- 1) 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<sup>4</sup>, 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.

<sup>11</sup> 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".

### III. PRACTICAL IMPLICATION OF THE LAW

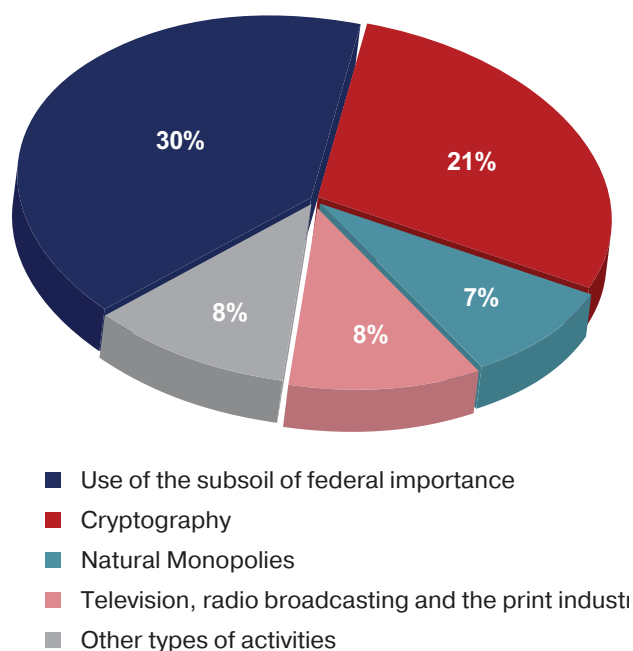
The following figures reflect the influence of the Law on the international transaction practice on the expiry of 2.5 years after its entry into force<sup>12</sup>:

In total the following were submitted to FAS:

- 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**



<sup>12</sup> 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](http://www.inkorp.ru/seminars/moscow/investicii_2010/#6)

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<sup>13</sup>;
- 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

<sup>13</sup> 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.

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## BUSINESS CASE. CREATING AN ENTERPRISE

### Investment opportunities for small/mid-size companies in Russia. Case study: Specta Group's production investment in the Kostroma region

Erik Helin, President, Specta Group AG



**Erik Helin**

Erik Helin is CEO of Specta Group; Member of the AEB Executive Board and Chairman of the AEB Executive Board Commission on Regional development

Specta Group is the leading industrial packing company in Russia, with its own production and nationwide distribution network in Russia and CIS. The company provides industrial packing, strapping, wrapping and marking machineries and materials in Russia. Main client segments are Steel, Metal, Sawn timber, Plywood, Paper, Corrugated, Glass, Polygraphic and Construction Material Industries.

In Addition to Russia, Mr Helin's international work experience covers USA, UK and Finland. He has a degree in Economics and Business Administration and since that, has also studied at IESE, IMD and INSEAD.

During his 20 years in Russia, Erik has always been involved primarily in Business to Business marketing (B2B) and with the steel industry. He was elected as a 'Metal Person of the Year' in 2007 for the best investment project in the Russian Steel Industry. He is the Member of the Russian Union of Metal and Steel Suppliers.

Erik Helin is a frequent speaker at Russian and foreign industry conferences on topics like strategy implementations, investments, management, regional development and cultural values in Russia.

Having spent more than a decade in Russia doing steel trading, transportation, import and distribution, I realized in the autumn 2004, the time was ripe for our company to invest into steel production in Russia. We needed to respond to the market growth.

#### Pre-project observations

While the Russian economy was then at the stage where all legal, tax, corporate laws and regulations were less developed than now, the market forces and the developing state institutions were able to

provide the solid platform to start the process of detailed investment feasibility study.

We observed many regions genuinely welcome foreign investment. Often, larger investment projects had been learning experiences not only for an investor, but for the local regional administrations as well. It was also noticed that the competence level of officials varied a lot, but the trend was positive; younger mayors and governors were soon to be appointed. The risk of the 1990's, of local authorities harassing the companies was fast changing into a regular dialogue between company managers and officials.

Both parties now expected professionalism from each other and not only listened, but actually 'heard' the other party. Without new modern investments, tax income, employment and other factors would have been adversely affected; hence, hindering a region's development in many ways.

The progressive Governors, their teams and the city mayors started to seriously promote their communities. The regions wanted to prosper, so they started to compete in terms of competences and opportunities for investment.

Surely, on the practical level, there were huge variances and one can not say that challenges were not faced, but we were convinced that the 'tide had turned' and was headed in a positive direction in terms of regional investment.

We went through a massive and time consuming process of checking 70 industrial sites in Central Russia's regions. We did technical and legal due diligences for 18 sites. Most sites we declined due to weak, non-existent or non-doable infrastructure issues. In 2005, there were no suitable industrial parks.

The crucial keys were electricity and railways. To address this issue from the scratch would have automatically meant an extension of the construction period by 1 to 2 years due to the shortage of designers, engineers and long permit procedures. We wanted to start production as quickly as possible.

The second reason was the concern of soil contaminations and future labor availability. We were concerned not so much about the possible lack of top managers, as we were about the availability of the skilled labor. The current and future human re-

source problem is not the ‘head-hunting’, it is the ‘hand-hunting’.

In many cases, we met enthusiastic, but at the same time skeptical authorities. Through the discussions we understood that they had met many foreigners, who were poorly prepared, or lacked any serious capability, or even an intention, to carry out an investment project in Russia. The authorities knew well – from the inside – that investing into Russia requires competence and localization.

Specta being a mid-size company could not afford to fail. The feasibility study had shown that the decision to invest presented considerable risks, but the opposite decision, not to invest, presented higher risks for the company’s development and enterprise value creation. After the feasibility study was completed, I spent the next few months motivating myself to a 100% commitment level, and subsequently, convincing the Board of Directors and Scandinavian Institutional State-owned Financiers, that it was time to rock’n’roll and capture this window of opportunity to invest to Russia!

Specta made a decision to invest 17 million euro into the production of high quality steel packing strap meant for binding steel coils, sheets, pipes, timber, plywood, construction materials and other heavy industrial products during the transportation.

### Project obstacles and approaches taken to solve them

As we all know, it is all about people; I first needed to build up a team. The core team was 16 people consisting of foreign steel strap production specialists, local steel mill managers experienced in cold rolled steel and its coating, construction, infrastructure and project managers, and marketing, human resource and financial managers.

It is worth mentioning that the project also included 9 lawyers from various legal areas. We tried to do our home work properly, thus, decreasing the risks. However, one can not fully eliminate all the possible risks in Russia.

While building up the team, the site selection was proceeding in full speed. In addition to infrastructure and labor issues, we wanted to be in a region that wanted our investment to allow us to bring something new to region’s industrial portfolio. To us, our investment, though from a financial standpoint not as large as foreign investments amounting to 100 million euro and over, still needed to be socially important to the community.

We did not want to invest into the region with one dominant employer. A diversified industry portfolio


was important, especially, with regard to its role in the future development of our investment.

In the steel industry, logistics often plays a key role. Most of our customers are located in Central Russia, Siberia, Urals or North-West Russia, and the key raw material suppliers are on the European side of Russia. Thus, in terms of logistics, the crossing point was to North-East from Moscow. The site was acquired in September 2005 in the Kostroma Region, in Kostroma City’s industrial zone, located just 3 km from the city with 300, 000 people.

The Region is very rich in timber assets and has a mechanical wood industry, saw mills, jewelry processing, machinery and engineering plants and a textile industry. It is the poorest region in the Central Federal District, and probably for this reason, it is often considered as remote – only 330 km from MKAD.

It is an important historical centre, the capital of Russia’s Golden Ring, thus, attracting 1 million tourists every year.

We presented our investment, team and concept for the local administration and made it crystal clear that the implementation time was critical. We needed to start to produce in 16 months time, starting January 2007.



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The AEB is pleased to offer a new opportunity on the AEB homepage [www.aeb.ru](http://www.aeb.ru) – a banner section. The AEB webpages have been viewed over 44,600 times in February 2011 only. The target audience is unique, by placing a banner you will reach the decision makers of the largest European companies operating in Russia. Companies are welcome to place advertisement banners in the section next to the Events calendar. There are two possible sizes: **200x47px or 200x94 px.**

**Price List**

		Price	
		200x47px	200x94px
Time frame (months)	Format and size		
1 month		500 Euro*	800 Euro
3 months		1000 Euro	1600 Euro
6 months		2300 Euro	3700 Euro
12 months (+ 1 month free)		5000 Euro	8000 Euro

\*All payments are to be made in Rubles according to the daily exchange rate set by the RF Central Bank on the date of payment.

**Contact person:**  
 For more info and to reserve a space, please contact **Svetlana Guzeeva, AEB Director of Communications,**  
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This offer extends to AEB members only. A 20% premium will be applied to these prices for non-Members. The prices given above do not include VAT.

The tri-party investment agreement was signed between the Region, the City and Specta.

The authorities ensured us that as long as all documents were done properly, the approval process will not be delayed. They promised total support in obtaining permits, not only from the municipal authorities, but also the federal ones, which are normally the time consuming ones.

The permit process is not difficult if you know how to do it, but one must have members within the team whose competences match or even exceed the level of the competency of the local authority. In Russia, professional courtesy is highly observed.

We did a lot of local PR and explained to the people what is our investment was all about and why it is good for the region. Our policy was to localize everything possible; we always chose the local vendors, designers etc when they were available; we created a wide horizontal network in the community and a positive climate for our investment. Specta's investment was not perceived as 'alien' or 'foreign'; it was the 'new local', with new standards for ethics, as well as environmental, energy-efficiency, modern management and human resource practices.

Before us, Kostroma had attracted a few other foreign investments; however, all this and the 'transitional effect' was quite new to Kostroma. Nevertheless, most people – not only young generation – felt the aspiration to be part of this. If there were a few persons willing to delay the process, they were quickly put back in line by the others. The project gained authority, and this authority provided the disciplined respect. Even lower ranking officials felt enthusiastic to see how things can be done properly and in very speedy manner.

The electricity connections and the construction itself presented rather big challenges. The project was a combination of brownfield and greenfield investment. To fully renovate a 25 years old infrastructure and combine it with something brand new proved to be more time-consuming and expensive than we had initially calculated. From the other side, the existence of the old railways saved us at least 1 year.

Specta's investment, the factory named OOO VolgaStrap, with an 11,000 square meter facility, started its commercial production on January 2<sup>nd</sup>, 2007, just 16 months after the site's acquisition.

The project was completed exactly on time and on the planned scale. It exceeded the original budget by 6%.

In summary, we could conclude that the key success factors were:

- Local;

- A large pool of committed project resources;
- Speed (long implementation time creates frustrations and increased risks for all stakeholders)
- Large local and international network of people, who helped with advice and support;
- Localized and fast decision-making on the spot.

## Current status of the project

After 4 years of production, the imported version of this product has been primarily replaced with the Russian product. All major steel and about 1000 other Russian industrial enterprises are using the locally produced and branded steel packing strap, Specta Prima and our other brands, for their packing needs. The factory is ISO 9001:2008 certified.

The competitiveness of the local industry has increased, as there is less material loss during transportation, and customers are receiving the goods in a reliably secured and packed form. It is important to mention that transport safety has increased.

The Kostroma Region now produces state of the art steel via an energy efficient technology that utilizes local raw materials and produces a finished, value-added steel product. Local infrastructure has improved.

The factory is exporting to all CIS countries, and also to Germany, Finland, Poland, Baltics, the Czech Republic, Slovakia and other countries. Many European steel majors are its clients, and it is gaining the market position of being the leading North European packing strap producer.

It received an award from the Ministry of Trade and Industry of the Russian Federation (RF) for being "The most dynamically developing exporting steel enterprise". It was also named as **"The best exporter in the industrial production sector" and "The best small business company in the industrial production sector" in the National Contest – "Gold Mercury" in 2009.**

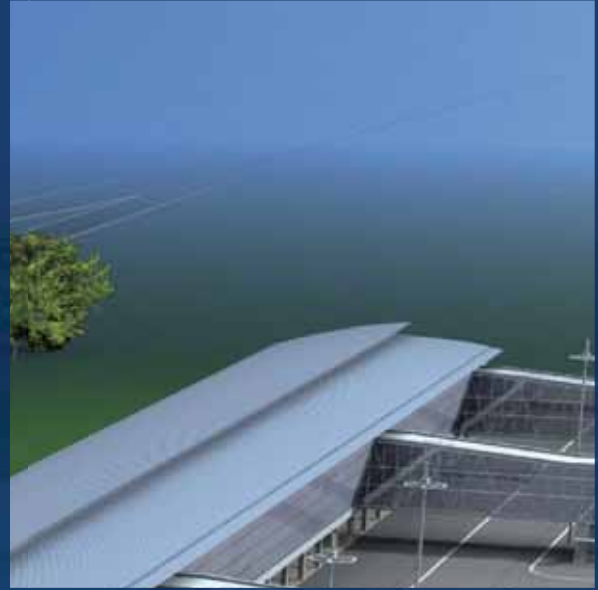
In addition, it won the competition in the steel industry, as the Best Investment Project in the RF Steel Industry in 2007, which was organized by the Russian Steel Suppliers Association. It was awarded a Golden Medal in the "100 best Russian products" category in the contest.

It is rare that a foreign owned company receives so much recognition from the Russian authorities and industry lobby. It indicates strongly that it does not matter to Russia if the investment is Russian or foreign-owned or SME-based, the main thing is the technology and added value.





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## Future opportunities, capitalizing on the project's successful completion in Kostroma

In 2011, Specta is further investing into the steel processing capacities and will be commissioning the production line for Polyethylene terephthalate (PET) – a plastic-packaging strap meant for packaging of lighter and mid-weight industrial goods, like for construction materials, corrugated and paper industry products.

On the factory's site, a mini-industrial park is being promoted. The site allows for the construction of 2 additional industrial buildings, about 2500-4000 sqm each. Since all infrastructure, communication links, office premises etc are ready, the site presents a viable opportunity for an investor, who wants to capture the market opportunities by strengthening his position through the establishment a production facility in Russia. It is suitable for:

- Small/Mid-size investments, which economically do not facilitate independent construction of infrastructure;
- Companies whose clients are in the North-West, Central, Volga and the Ural regions;
- Companies whose clients are pulp, paper, saw-mills or wood processing industries;
- Metal processing or mechanical engineering;
- Assembly and after sales/service operations;
- Small and Medium sized companies, which lack experience in investing in Russia;
- Companies that need to start to operate and produce within 8 to 9 months.

The site with a fully equipped infrastructure, successfully resolved issues pertaining to utilities, soil and other issues, provides an industrial park concept like 'shell and core' for an investor:

- 1) Long-term land lease: The investor will finance the construction costs of its building and pay a one-time fee for the 'shell and core' i.e. for the already existing operational infrastructure,
- 2) Specified project services like permits;
- 3) Operating services:
  - electricity, cold and hot water, sewage, heating and/ or conditioning
  - Security, cleaning
  - office & temporary warehouses premises
  - IT infrastructure & facilities
  - Legal support, Book-keeping, HR support.

The Project has several attractions for an investor:

- Good location for production investment and away from Moscow/St Petersburg's high cost area;

- Already resolved Infrastructure and Environmental issues;
- Developer has completed its own factory project, and stays at the site;
- Developer can render Project and other Management Services;
- Close proximity to the City eases the labor recruitment;
- Region and City authorities are in support of sustaining the project as being one of the foreign flagship investments in the Region.

Russia's traditionally strong steel and metal industry represents numerous opportunities for European technology investments. The downstream investments producing finished goods represent an untapped area to accelerate the diversification and modernization of Russia's economy.

## PROSPECTS OF INVESTING FOR THE FUTURE

### Moscow as an international financial centre

Alexey Plekhanov, Principal Economist, Office of the Chief Economist,  
European Bank for Reconstruction and Development



**Alexander Plekhanov**

Alexander Plekhanov is a principal economist in the Office of the Chief Economist at the European Bank for Reconstruction and Development in London. His main responsibilities include country work on Mongolia and Russia, analysis of the financial sector developments, and economic data management.

Alexander joined the Bank in October 2007. Prior to that, he worked as an economist at the International Monetary Fund in Washington, DC, in the Western Hemisphere Department and Fiscal Affairs Department.

Alexander holds an M.Phil. in Economics and Ph.D. in Economics from the University of Cambridge and a Diploma in Mathematical Economics from St. Petersburg State University. He wrote several papers on various economic issues, including financial deepening and commodity-based development and economic diversification.

In summer 2008, the Russian government launched an initiative to promote Moscow as an International Financial Centre (IFCentre). The initiative was first mentioned in the address of President Medvedev to the St. Petersburg International Economic Forum. The timing of the launch may have been somewhat unfortunate, perhaps even ironic – only a couple of months later the wave of the global economic and financial crisis hit hard the Russian economy and Russia's financial system. During the following year, Russia experienced the steepest recession among the G20 countries as output contracted by 7.9 per cent in real terms, the stock of credit declined, and the stock market valuation experienced a sharp correction.

Yet, the initiative survived through difficult times. Not only did it survive, but it also gained renewed momentum as Alexander Voloshin, former head of the Presidential Administration, was appointed to head a task force to look into the issue, and various legislative acts were drafted and passed.

### What does it take to be an international financial centre?

Is Moscow not an IFCentre already? As a concept, an IFCentre is hard to define precisely. If one looks at major international financial firms operating in Moscow, they have been present for many years, in some cases running regional operations in the CIS out of Moscow, and local, Moscow-grown, banks and investment banks are increasingly establishing global presence. On the other hand, if one looks at foreign listings in Moscow, they are absent. If one looks at various rankings of IFCentres, Moscow is already there, but typically, quite far away from the top, while not far away from St. Petersburg. Overall, the picture is mixed, but Moscow is probably not yet the IFCentre it hopes to be. Moreover, there is no clear benchmark for when Moscow becomes an IFCentre (of major significance). Like with so many things, we will know it when it happens.

Can Moscow become an IFCentre? This is definitely within the realm of the achievable. One can cite numerous examples of a very rapid rise of cities on the map of financial services, both regional hubs (Labuan – Malaysia, Manama, Bahrain) and global centres (Hong Kong, Singapore). At the same time, creating an IFCentre is a very challenging task, due to relentless global competition and the importance of clustering effects. To create one, it is crucial to establish a critical mass of customers: financial services firms tend to benefit from each other's proximity and cluster together. At the same time, an ever increasing number of cities world-wide develop ambitions to become IFCs. For instance, the Istanbul Stock Exchange has recently marked its first foreign Initial Public Offering (IPO).

In this highly competitive environment, Moscow would need to find a niche for itself among alternative financial centres around the globe, leveraging its geographic location, the increasing role and size of the Russian economy and its natural resource wealth.

International experience does not give a clear recipe for building a successful IFCentre. In some instances, the emerging centres rode the wave of specific new products and concepts (Islamic finance in the case of Dubai and Kuala Lumpur), in others they stepped in to fill the gap caused by disruptions else-

where (for instance, Manama succeeded in attracting business from Beirut during armed conflicts in Lebanon), others started by catering to the off-shore industry. Geographical location and cultural links may also be important, for instance in the case of Hong Kong serving large parts of the market of mainland China.

Yet the overall experience suggests that IFCentres tend to enjoy competitive advantages in the three key areas: strong core banking system, with a transparent governance structure and clear assignment of responsibilities for regulation and supervision of financial institutions; widely accepted and tested legal and technical infrastructure needed to support financial markets; and the broader institutional environment and business climate. All three dimensions featured prominently from the start in the Moscow as IFCentre initiative, and all three are highly complementary: whatever the state-of-the-art technical infrastructure, it is hard to imagine an *international* financial centre without expatriates willing to come to Moscow, and stay there. And if the legal framework is unclear and a dispute cannot be settled in a cost-effective way, Moscow will be a hard sell for international investors, even if one can get from the airport to the financial heart of the city in forty minutes.

In addition, even with all these benefits in place, potential market players will also be looking at the costs. It is clearly important to lower the effective cost of doing business for market participants – especially, in terms of available skilled human capital in Moscow. This undoubtedly includes financial skills and language skills, but there are also numerous soft factors that determine attractiveness of financial centres and effective costs of doing business there, such as comfortable living environment for expatriates – these are much more difficult to measure and benchmark objectively.

## Core financial system

Before going into the specifics on the financial markets, where Moscow could develop a competitive edge, it is important to emphasise that the key to any financial centre is the well-functioning core banking system – sound commercial banks subject to effective regulation and supervision. It is true of the financial systems that host world's top financial centres – UK, US, Switzerland, Japan, Germany, Hong Kong, Singapore – and it is also true, albeit at a different level, of the major regional financial centres. The ultimate objective is to have a banking system that can be trusted by international players, and to maintain this trust.

Over the years, Russia has made important progress in strengthening this aspect of finance, though there is more to be done. Like elsewhere, the global liquidity squeeze after the collapse of Lehman Brothers put substantial pressure on financial intermediaries, which was further exacerbated by massive capital outflows against the background of plummeting oil price, and a rapid dollarization of the deposit base as confidence of households in the rouble proved to be fragile (the share of foreign currency deposits in total household deposits jumped from 9 to over 32 per cent in a matter of months before declining again). The authorities forcefully intervened to secure the stability of the banking system, drawing on substantial fiscal savings and a large stock of international reserves. The broad package of measures helped to stabilize the situation in the financial sector. Going forward, vulnerabilities in the banking system need to be reduced further, while the range of financial institutions must broaden and the financial markets supporting these institutions deepen.

## Rouble capital markets and technical and legal infrastructure

In this respect, one of the key tasks is to further develop deep and liquid rouble capital markets, including developing well-functioning markets in futures and derivatives. While they may not be always in fashion after the global financial crisis, they help to achieve a number of overarching policy objectives, which in fact go beyond the creation of an IFCentre.

Firstly, they are vital to the lengthening of contract maturities in loan, bond and hedging instruments and in establishing a reliable term structure of interest rates. Availability of longer maturities and the presence of a reliable rouble yield curve will enable financial institutions to improve management of their aggregate interest rate and exchange rate exposures, a particularly important task in the still high-inflation and volatile interest rate environment. Better management of individual interest rate exposures will in turn reduce liquidity risk and the overall vulnerabilities in the financial system.

Improvements in interest rate hedging instruments and related exposure management will also facilitate transition from exchange rate targeting to inflation targeting by the Central Bank, a necessary shift in the monetary policy anchor as the rouble moves towards becoming an international reserve currency. The latter is in fact an important consideration, since major IFCentres and major reserve currencies – US dollar, Euro, Japanese Yen, British

Pound, and Swiss Francs – tend to go hand in hand. The currencies of other major financial centres are also widely traded and are of major significance for the region (Hong Kong dollar, Singapore dollar, Australian dollar among others). Although inflation in Russia has been declining recently, it still remains both higher and more volatile than in the leading financial centres and most BRIC countries (see chart 1).

In addition, well-functioning markets in futures and derivatives will enable financial institutions to better design and implement appropriate internal fund transfer-pricing mechanisms, leading to enhanced efficiency of loan operations, improved identification of the most profitable activities, and ultimately efficient allocation of capital in the system as a whole. Transparent internal transfer pricing mechanisms are important to correctly identify and distinguish liquidity risk from credit risk.

Lastly, Moscow has a natural advantage as a centre for trading rouble instruments, and could thus, target international investors seeking liquid and diversified exposure to the rouble. Attractiveness of the rouble will in turn be determined by the size and strength of the Russian economy and the success of diversification efforts. The latter are important not only in terms of overall prospects for the economy, but also directly in terms of status of the rouble: if the currency were perfectly correlated with the price of oil, investors might well opt for oil-linked contracts.

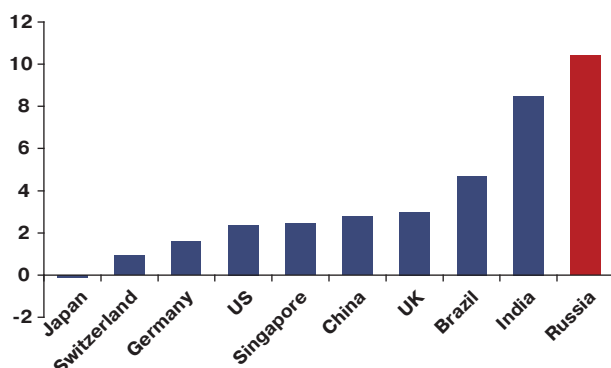
Establishing a risk-free interest rate, a key benchmark for the financial markets, is another major challenge in an environment, where federal government borrowing has been limited, and may (many would argue, should) remain so. Indeed, Russia's high dependence on commodities (oil and gas alone account for over two thirds of merchan-

dise exports) calls for building up substantial buffers in terms of sovereign savings. Indeed, prior to the crisis Russian Stabilisation Funds – the Reserve Fund and the National Welfare Fund – accumulated around 15 per cent of GDP in resources, while general government debt had been reduced to single-digit levels. While in the last year, the government has been running down reserves to support the economy and stepped up debt issuance in both domestic and Eurobond markets, over the long run one would expect accumulation of assets in sovereign wealth funds to resume (for instance, assets of Norway's sovereign wealth fund exceed 70 per cent of GDP; in Bahrain, mentioned above, they exceed the 60 per cent mark).

Hence, sovereign debt issuance may remain limited relative to the needs of capital markets development. In these circumstances, sufficiently broad and deep markets for rouble interest rate swaps (IRS) will be instrumental in establishing an alternative risk-free benchmark to supplement that of the federal government.

Deeper markets in futures and derivatives can build on the existing open architecture of MICEX, better exploiting its existing infrastructure and potential. But full realisation of these objectives relies on successful implementation of a number of important, primarily legal and regulatory measures, putting emphasis on careful prioritisation from the outset. A number of important steps have already been taken, including the carve-out for derivatives from the gambling provisions of the Civil Code – although this needs to be broadened to all counterparties -, recognition of specific derivative and repo transactions, and the creation of the National Settlement Depository. Other steps are yet to be taken, including the removal of obstacles to effective net-

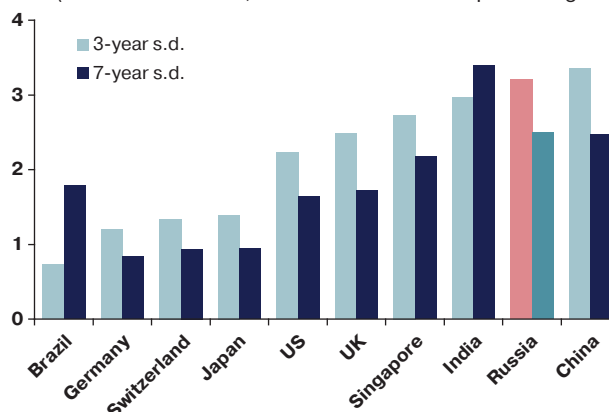
**CPI Inflation, 5-year Average**  
(selected countries, in per cent)



Sources: IMF and EBRD calculations, based on monthly data for the 5-year period ending September 2010.

**Inflation Volatility**

(selected countries, standard deviations in percentage)



Sources: IMF and EBRD calculations, based on monthly data for the period ending September 2010.



ting and collateralisation, changes to the pledge law and related acts, clarification of accounting and tax treatment of certain hedging instruments. To enable the rouble financial markets to form part of the international capital markets, the respective legislation and regulation should be consistent with international standards.

As a financial system constantly innovates, the relevant legislation should also allow for substantial flexibility. Neither permissible counterparties (that in the case of international financial centre would need to include major corporations and foreign-owned financial institutions) nor permissible financial instruments need to be defined in primary legislation, which should provide only a loose definition of derivative instruments and specify the appropriate regulator who will define permissible counterparties and derivatives at a sub-regulatory level. This will allow these categories to be updated by the regulator in-line with market innovations, as well as policy priorities such as emissions trading.

## Overall business environment

Finally, one cannot overstate the importance of overall business environment. To assess the quality of the investment climate and the severity of various constraints to firms' operations, the European Bank for Reconstruction and Development and the World Bank conduct a Business Environment and Enterprise Performance Survey (BEEPS) in all countries in the Emerging Europe and Central Asia regions. The latest round of the survey completed in 2008-09 covered over 1, 200 manufacturing and services firms in Russia. As part of this survey respondents were first asked to single out the most important obstacle to doing business and then to rank each one of fifteen potential obstacles to firm's operation independently on a scale of negligible – minor – moderate – major – very severe.

Compared with the new member states of the European Union, Russian firms were much more likely to single out corruption, licensing and permits or access to land as the key obstacle to doing business (these were mentioned by every fourth respondent). Customs and trade regulations were also mentioned more frequently. By contrast, tax rates and tax administration were emphasised by approximately one in five respondents, less frequently than in the new EU member states on average. When firms were then asked to assess each obstacle individually, inadequate workforce skills came out as the top obstacle with 56.6 percent of firms ranking it as "major" or "very severe"; corruption came

in second place with 50.1 per cent of respondents classifying it as a "very severe" or "major" obstacle. Access to land came in at third place.

Although the survey did not target financial services firms in particular, the key obstacles would most probably be similar. In addition, the financial sector may particularly welcome further streamlining of visa and work permit procedures regarding highly-qualified foreign workers. Some measures facilitating their employment have already been taken.

This long list of measures and reforms that would pave the way towards establishing a major IF-Centre may seem daunting, but it need not be. What is good for transforming Moscow into an IFCentre is good for the development of the Russian economy overall, and vice-versa. This is the key reason why Russia needs an IFCentre in Moscow.

## WTO, Russia's centerpiece for modernization

Prof. Art Franczek, President, American Institute of Business and Economics



### Art Franczek

Art Franczek, president of AIBEC and professor of Accounting.

Art is currently the president of The American Institute of Business and Economics in Moscow (an English language MBA program that was founded in 1989). He holds degrees

in History and Political Science in addition to an MBA, CPA and a Masters of Taxation. In addition to managing AIBEC he teaches courses in IFRS, Taxation and Cost Management. He has served as a consultant for the Russian Central Bank (IAS 39), the World Bank (on implementing IFRS in Russia), The Bank of Albania (implementing IFRS and IAS 39) and has written many articles on IFRS, Customs and Taxation issues in addition to a book on IFRS. Art is also co-chair of the Customs Committee at Am Cham and was awarded co-chair of the year.

Prior to coming to AIBEC Art served as a business consultant in Togliatti after working for many years as a Corporate Tax Manager for a Fortune 1000 company.

Since 1993 when Russia first applied for membership in the General Agreement on Tariffs and Trade (GATT) it has come close on a number of occasions. In 2006 Putin was planning to showcase the US/Russia World Trade Organization (WTO) accords at the G-8 Summit in St. Petersburg. This effort was thwarted when the Russians discovered that American meat inspectors didn't wear slippers (topichiky). The press announced that 2008 would be the year that the accession process would be completed. Plans changed when Russia and Georgia entered into a conflict. Some prominent Americans wanted to throw Russia out of the G-8 and ban it from WTO. Accession plans were again delayed in 2009 when Russia announced that it would enter WTO as part of the Customs Union. Most analysts and Kremlin officials agree that 2011 will be the year that Russia joins WTO.

In the past 17 years there has been strong resistance to WTO Oleg Derispaska an owner of auto, aluminum and airplane producing companies opposed WTO accession because he considered his companies infant industries that would be greatly hurt by Russia's accession. The Russian Chamber of Commerce resisted WTO accession because Russia's main ex-

ports were commodities that enjoyed easy access without WTO protection. Agricultural industries were concerned that WTO would cause subsidies to be limited. The Russians also used Sanitary and Phytosanitary (SPS) regulation to limit meat and poultry imports.

World Bank studies estimate that Russia's GDP will increase by 3.3% in the near term and 11% in the long term as a result of WTO accession. The increase in GDP comes from a number of areas. Overall tariff rates will come down from 10.1% to 7.1% this will lead to increased imports at reduced costs of inputs for production. A major benefit will be from the liberalization of barriers for international services. Banking and Insurance will be allowed to 50% share of the market rather than 15%. Foreign providers of telecommunications will be allowed to compete in the long distance fixed line service. These enhancements should lower the cost of doing business and should lead to productivity gains for firms using these services.

WTO accession can benefit Russia in several ways. For example, discrimination against Russian companies would be minimized. This could help Russian steel companies who are often subjected to antidumping rules. Russia would gain access to WTO mechanisms for settling trade disputes. WTO accession would provide external support for many internal reforms in the areas of trade. Competitive pressures on local producers would encourage them to become more efficient and innovative. Evidence suggests that FDI will increase significantly after WTO accession. In China's first year after accession FDI increased by 18% and WTO greatly contributed to China's near double digit annual growth over the last decade.

The import of pork and poultry and poultry into Russia has been a difficult issue for the last 18 years. Sanitary and Phytosanitary (SPS) have been arbitrarily used to ban or limit meat imports. The Russian inspectors claim that US chickens which are cleaned with chlorine are unsafe. European pork is regularly rejected because of a violation that is not even explained. When Russia accedes to WTO it will be required to use science based transparent rules with regard to the safety of meat and other products.

In 2007 Russia increased the export duty on timber from 6.5% per cubic meter to 25% per cubic meter in an effort to encourage lumber production in Russia. This increase created a great burden for Finland's lumber production industry. As part of Russia's December agreement with the EU Russia agreed to ban tariffs on timber.

One of the most contentious areas of tariff negotiation was civil aircraft. Tariffs on wide body aircraft will be reduced from 20 to 7.5% in the four years following accession. The reduction of tariffs 30% to 15% (in the next 7 years) on imported cars will encourage competition in this industry.

Russia has recently signed trade agreements with the EU and the US in which Russia has committed to WTO's thick catalog of rules guaranteeing market access and protecting foreign investors. Legislation was recently passed to improve the implementation of Intellectual Property Rights and Data protection for Drug companies. Russia has also promised to ease import controls on electronic goods containing encryption. This is major issue related to Russia's Innovation initiatives.

In 2008 Russia passed legislation that limited investment in 42 strategic industry sectors. However, President Medvedev recently announced that he would slash this number by 80% and that capital gains tax on foreign direct investment (FDI) would be eliminated. It is likely that the Cold War relic Jackson Vanik will be repealed after Russia completes its accession process and US companies want to access WTO benefits. It is also likely that Georgia will be persuaded by the US to withdraw its opposition to Russia's WTO accession.

On January 1, 2010 the first stage of the Customs Union between Kazakhstan, Belarus and Russia came into effect. The Customs Union establishes a single Customs Territory in which free movement is provided for goods either originating from its territory or imported from third countries that have entered into free circulation. The first stage of the Customs Union was the implementation of the Customs Tariff Law that harmonizes tariffs on over 11,500 goods among the participating countries. The Customs Union Customs Code was implemented on July 1, 2010.

The Customs Union is the first stage of what will become a Common Economic Space (CES) by 2012. The CES will be comparable to the European Union and will allow for free movement of goods, services, capital, and labor. The process of economic integration will be complex and has already resulted in delays of goods at the new borders. However, after 5 years, the Gross Domestic Product (GDP) of this region is expected to increase by 15% and many investment opportunities in manufacturing, assembly and other areas will emerge for multinational companies. It is likely that other countries such as Ukraine may be invited to join what has been referred to as the "Soviet Reunion".

Innovation and Modernization have become "buzzwords" for the Medvedev/Putin administration. This is no surprise because Russia spends about

1.5% of its GDP on Information Technology while the US spends about 3% of its GDP. In March, Arkady Dvorkovich and some leading Russians attended a seminar at the Massachusetts Institute of Technology (MIT) on Innovation. In June, President Medvedev and his entourage visited Silicon Valley and with Steve Jobs of Apple, John Chambers of Cisco, Sergey Brin of Google and others, to experience Innovation for himself. These activities set the stage for the big announcement of Russia's Silicon Valley. Over the next three years, the government will build offices, apartments, and laboratories at the Skolkovo Innovation Center. Victor Vekselsberg, the center's director invites innovators to "Come, live, create and do good for yourself, Russia and the whole of civilization." So far, Cisco Systems is planning to invest a billion dollars and Nokia has promised to invest in this project.

Businesses that set up at Skolkovo will receive cheap rents, a 10 year exemption from income tax, lower social security payments, reduced customs duties, and minimal bureaucracy. In exchange, the residents will be expected to develop new technologies for the country and to sell to the rest of the world. It is hoped that the Skolkovo innovators take a look at India and its development of techno-austerity. They have developed the Nano, a car that sells for \$2,200, and a \$70 fridge among other frugal innovations. It is my hope that Skolkovo understands the wisdom – "Frugality is the mother of Invention".

Recently, Russia announced it would sell non-controlling shares in some state companies to raise 50 billion dollars. Aleksei Kudrin strongly emphasized that these asset sales would be transparent and at fair value, in contrast to the Loans for Shares giveaway in the mid 1990s. Companies such as Rosneft, Sberbank, VTB and others will offer shares to foreign investors. This "Reprivatization" reverses the trend toward state ownership that occurred in the first part of this century. These asset sales may provide an incentive for the Russian government to improve property rights and corporate governance so that these assets can be sold to investors.

Doing business in Russia is not easy; in fact, Russia ranks 120<sup>th</sup> out of 180 countries in the World Bank Survey and many critics claim that Russia will never change. I have just described a few of the concrete steps Russia is taking to integrate into the world economy and move away from its dependence on oil. President Medvedev referred to recent events between Russia, the US and EU as a "paradigm shift", in which common goals could be pursued and Russia could fulfill its need for "modernization alliances". At Sochi in 2014 and FIFA in 2018, Russia will want to showcase the "New Russia" to the world.

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**АССОЦИАЦИЯ  
ЕВРОПЕЙСКОГО БИЗНЕСА**

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**AEB MEMBERSHIP APPLICATION FORM / ЗАЯВЛЕНИЕ НА ЧЛЕНСТВО АЕБ**

Please fill out the Application Form in **CAPITAL** letters, sign it and fax it to **234 28 07**/

Заполните заявление печатными буквами и пришлите по факсу **234 28 07**

Calendar year / Календарный год: **2011**  (Please check the appropriate box/boxes / Укажите соответствующий год/года)

**Name of your AEB Contact / Ваше контактное лицо в АЕБ:** \_\_\_\_\_

**1. COMPANY / СВЕДЕНИЯ О КОМПАНИИ**

**Company Name in full, according to company charter. (Individual applicants: please indicate the company for which you work /**  
Название компании в соответствии с уставом. (Для индивидуальных членов – название компании, в которой работает заявитель):

**Legal Address (and Postal Address, if different from Legal Address) /**  
Юридический и фактический адрес, если он отличается от юридического:

**INN / KPP / ИНН/КПП:**

**Phone Number /** Номер телефона:

**Fax Number /** Номер факса:

**Website Address /** Страница в интернете:

**2. CATEGORY / КАТЕГОРИЯ:**

**THE CATEGORY IS DETERMINED ACCORDING TO THE COMPANY'S WORLD TURNOVER**

<b>Please indicate your AEB Category /</b> Отметьте категорию	<b>Company's world-wide turnover</b> (euro per annum) / Мировой оборот компании (евро в год)	<b>AEB Membership Fee /</b> Членский взнос в АЕБ
<input type="checkbox"/> <b>SPONSORSHIP /</b> Спонсорство	–	<b>8,500 euro/евро</b>
<input type="checkbox"/> <b>CATEGORY A /</b> Категория А	<b>&gt;500 million/миллионов</b>	<b>5,750 euro/евро</b>
<input type="checkbox"/> <b>CATEGORY B /</b> Категория Б	<b>50–499 million/миллионов</b>	<b>3,500 euro/евро</b>
<input type="checkbox"/> <b>CATEGORY C /</b> Категория С	<b>1–49 million/миллионов</b>	<b>2,000 euro/евро</b>
<input type="checkbox"/> <b>CATEGORY D /</b> Категория Д	<b>&lt;1 million/миллионов</b>	<b>750 euro/евро</b>
<input type="checkbox"/> <b>INDIVIDUAL (EU/EFTA citizens only) /</b> Индивидуальное (только для граждан Евросоюза/ЕАСТ)	–	<b>750 euro/евро</b>

**Any non-EU / non-EFTA Legal Entities applying to become Associate Members must be endorsed by two Ordinary Members (AEB members that are Legal Entities registered in an EU / EFTA member state or Individual Members – EU/EFTA citizens) in writing/**

Заявление любого юридического лица из страны, не входящей в Евросоюз/ЕАСТ, и желающего стать членом АЕБ, должно быть письменно подтверждено двумя членами АЕБ (юридическими лицами, зарегистрированными в Евросоюзе/ЕАСТ, или индивидуальными членами – гражданами Евросоюза/ЕАСТ)

**Individual AEB Membership is restricted to EU / EFTA member state citizens, who are not employed by a company registered in an EU / EFTA member state /**

К рассмотрению принимаются заявления на индивидуальное членство от граждан Евросоюза/ЕАСТ, работающих в компаниях, страна происхождения которых не входит в Евросоюз/ЕАСТ

**Please bear in mind that all applications are subject to the AEB Executive Board approval /**  
Все заявления утверждаются Правлением АЕБ

**3. CONTACT PERSON / INDIVIDUAL MEMBER / КОНТАКТНОЕ ЛИЦО / ИНДИВИДУАЛЬНЫЙ ЧЛЕН**

<b>Title, First Name, Surname / Ф.И.О:</b>	
<b>Position in Company / Должность:</b>	
<b>E-mail Address / Адрес эл. почты:</b>	



4. COUNTRY OF ORIGIN / СТРАНА ПРОИСХОЖДЕНИЯ	
<b>A. For a company</b> / Компаниям: <b>Please specify COMPANY'S country of origin /</b> Указать страну происхождения компании <sup>1</sup>	
<b>or B. For an individual applicant /</b> Индивидуальным заявителям: <b>Please specify the country, of which you hold CITIZENSHIP /</b> Указать гражданство	
<p><b>Please note that only EU / EFTA members can serve on the Executive Board and the Council of National Representatives/</b> Внимание! В Совет национальных представителей и Правление могут быть избраны члены, представляющие страны Евросоюза или ЕАСТ.</p> <p><b>Please fill in either A or B below/</b> Заполните только графу А или В</p>	

5. COMPANY DETAILS / ИНФОРМАЦИЯ О КОМПАНИИ			
<b>Company present in Russia since:</b> _____ / Компания присутствует на российском рынке с: _____ г.			
<b>Company activities /</b> Деятельность компании	<b>Primary /</b> Основная:	<b>Secondary /</b> Второстепенная:	
<b>Company turnover (euro) /</b> Оборот компании (в Евро)	<b>In Russia /</b> в России:	<b>Worldwide /</b> в мире:	<input type="checkbox"/> Please do not include this in the AEB Member Database/ Не включайте это в справочник АЕБ
<b>Number of employees /</b> Количество сотрудников	<b>In Russia /</b> в России:	<b>Worldwide /</b> в мире:	<input type="checkbox"/> Please do not include this in the AEB Member Database/ Не включайте это в справочник АЕБ
<p><b>Please briefly describe your company's activities (for inclusion in the AEB Database and in the AEB Newsletter) /</b> Краткое описание деятельности Вашей компании (для включения в базу данных АЕБ и публикаций АЕБ)</p>			

6. HOW DID YOU LEARN ABOUT THE AEB / КАК ВЫ УЗНАЛИ ОБ АЕБ?	
<input type="checkbox"/> <b>Personal Contact</b> / Личный контакт	<input type="checkbox"/> <b>Internet</b> / Интернет
<input type="checkbox"/> <b>Media</b> / СМИ	<input type="checkbox"/> <b>Event</b> / Мероприятие
<input type="checkbox"/> <b>Advertising Source</b> / Реклама: _____	<input type="checkbox"/> <b>Other</b> / Другой: _____

**Signature of Authorised Representative of Applicant**  
Company / Подпись уполномоченного лица заявителя:

**Signature of Authorised Representative of the AEB /**  
Подпись Руководителя АЕБ:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_  
Date/Дата:

\_\_\_\_\_  
Date/Дата:

<sup>1</sup> Location of a parent company or of the main shareholder / Местонахождение головной конторы или основного учредителя.

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# LEGAL SERVICES IN RUSSIA: **BEITEN BURKHARDT.**

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