

Since the outbreak of the crisis the government has increased its efforts to safeguard the economy. By April 2009 approximately a third of Russia's foreign currency reserves had been spent on implementing a step-by-step rouble devaluation, which prevented panic and an inevitable run on the banks. The Central Bank has provided commercial banks with liquidity through REPO mechanisms in an attempt to unfreeze the credit market. However, as of April 2009 short-term financing at reasonable rates was still unavailable for most small and medium-sized enterprises. The government has proposed bail-out initiatives for the economy's largest companies with a view to limiting the negative social impact of massive lay-offs. Some banks and financial services companies have been acquired by government-controlled organizations. The authorities have come up with a multi-billion dollar rescue plan for the automotive sector and are subsidizing rates on car-loans for cars produced or assembled domestically. A package of tax initiatives encouraging economic activity has been adopted.

The Economist Intelligence Unit mentions that among the strong points of the Russian economy are comfortable savings levels, very limited exposure to the stock market (less than one million Russians own shares) and low exposure to the mortgage market compared to the US, the UK and the Central and Eastern European countries. On the downside are the drops in real income, real wages, disposable income and retail sales, and the increasing unemployment, which currently stands at between 7 and 8%.

The prospects for an upturn in the Russian economy remain unclear and largely depend on how long the recessions in the US and world economy last. According to the Economist Intelligence Unit, if global demand shrinks and oil prices in 2009 fall below 45-53 USD per barrel (seen as the critical level for the state budget), the rouble will come under more pressure and the recession in the Russian economy may last until Autumn 2010 or beyond.

2. PROMOTING FOREIGN INVESTMENT IN RUSSIA

2.1 The Foreign Investment Law

2.1.1. General Provisions Regarding Foreign Investments.

The *Constitution of the Russian Federation* (the *Constitution*), the *Civil Code of the Russian Federation* (the *Civil Code*), and other legislation on joint stock and limited liability companies and their insolvency provide the general legal framework for trade and

investment in Russia. Foreign investments are regulated by the Federal Law *On Foreign Investments in the Russian Federation*, dated 9 July 1999 (the *Law on Foreign Investments*). However, the *Law on Foreign Investments* does not apply to the investment of foreign capital in banks, credit organizations, insurance companies or non-commercial organizations; foreign investments in such entities are regulated under different Russian legislation.

The *Law on Foreign Investments* guarantees foreign investors the right to invest and to receive revenues and profits from such investments, and sets forth the terms for foreign investors' business activity on the territory of the Russian Federation.

The objective of the *Law on Foreign Investments* is to attract foreign materials, financial resources, and technology and management skills to improve the Russian economy, while providing stability for foreign investors. The *Law on Foreign Investments* is aimed at the Government of the Russian Federation conforming to standards of international law and to international standards of investment cooperation.

The *Law on Foreign Investments* emphasizes the role of both federal and regional legislation, and stipulates that foreign investors and investments must be treated no less favorably than domestic investments, with some exceptions. Such exceptions may be introduced to protect the Russian constitutional system, the morality, health and rights of persons, or in order to ensure state security and defense.

The *Law on Foreign Investments* permits foreign investment in most sectors of the Russian economy: portfolios of government securities, stocks and bonds, direct investment in new businesses, the acquisition of existing Russian-owned enterprises, joint ventures, *etc.* Foreign investors are protected against nationalization or expropriation unless such action is mandated by a federal law. In such cases, foreign investors are entitled to receive compensation for any investment and other losses.

One of the most important features of the *Law on Foreign Investments* is the tax stabilization clause set forth in Article 9. Under Article 9.1, the Law's tax stabilization clause, also known as "the Grandfather Clause", applies to i) foreign investors that are implementing "priority investment projects", ii) Russian companies with more than 25% foreign equity ownership, or iii) Russian companies with some foreign participation that are implementing "priority investment projects."

Article 2 defines a priority investment project as a project with foreign investment of at least one billion rubles (about USD 41 million at current exchange rates), or

where a foreign investor has purchased an equity interest of at least 100 million rubles (about USD 4.1 million at current exchange rates); in either case, the investment project must also be included in a list of projects approved by the Russian Government.

For qualifying companies and projects, the Grandfather Clause prohibits increases in the rates of certain import duties and federal taxes until initial investments have been recouped (up to a maximum of seven years, unless this period is extended by the Russian Government under certain conditions). Key exceptions to the Grandfather Clause are established for protective customs tariffs on commodities, excise tax, VAT on domestic goods, and Pension Fund payments. Article 9.4 provides a further and potentially broad exception for laws protecting certain public or state interests. Article 9.5 contemplates the adoption of regulations to implement the Grandfather Clause. Given all of these exceptions and qualifications, it remains arguable whether the tax stabilization clause is of real benefit to foreign investors.

2.1.2. Restrictions on Strategic Companies

Certain restrictions for foreign investments are imposed by *Russian Law No. 57-FZ of April 29, 2008 “On the Procedures for Foreign Investments in Companies of Strategic Significance for National Defense and Security”* (the “*Law on Strategic Companies*”). The Law on Strategic Companies is designed to regulate *the acquisition of control* over Russian strategic companies by foreign investors or “groups of persons” that include a foreign investor. Acquisitions by such entities of control, including through acquisitions of shares, in strategic companies require the *preliminary consent of the Russian Government and/or a post-transaction notification*.

The Law on Strategic Companies provides a list of more than 40 activities that constitute strategic activities in Russia. Accordingly, any company engaged in such activities is viewed as a strategic company. The strategic activities include, among other activities, the following:

1. Works having an active impact on geophysical processes;
2. Works related to hydro-meteorological processes and events;
3. Activities related to the use of infectious agents;
4. Activities related to the nuclear industry and the storage of nuclear and radioactive materials;
5. Activities related to encryption and licensed encryption techniques;

6. Activities related to the secret obtaining of information in premises and equipment (excluding the activities performed for the purposes of security of legal entities);
7. Activities related to the production, trade, repair and utilization of weapons and military equipment, and their spare parts and ammunition (excluding cold arms, civil and service weapons) and explosive materials for industrial purposes;
8. Activities related to aviation equipment and security;
9. Space activities;
10. Activities related to telecasting or radiocasting on territory, where half or more of the population of the constituent of Russia resides;
11. Services provided by a company included in the register of natural monopolies, (excluding natural monopolies in public telephone and wireless communication and postal communications fields, and services for the supply of heat energy and electrical energy through the distribution grid);
12. Activities performed by a company included in the register of companies having more than a 35% market share in a particular market of goods and occupying a dominant position in the following fields:
 - The market of communication services on the territory of Russia (excluding services for providing access to the Internet);
 - The market of fixed telephonic communication on the territory of five or more constituent territories of Russia;
 - The market of fixed telephonic communication on the territory of Moscow and St. Petersburg.
13. Activities related to geological research of the subsoil and/or mineral exploration and extraction on federal subsoil;
14. Procurement of water biological resources (fishing);
15. Performance of printing by a commercial entity, if such commercial entity is capable of printing no less than two hundred million impression prints a month; and

16. Performance of editorial office activities and/or activities of a periodical publisher, publishing editions with individual circulations of no less than one million.

Therefore, from the standpoint of foreign investment, it is important to verify all activities the investor's company is engaged in to properly assess whether it may be viewed as strategic and therefore subject to certain restrictions.

2.1.3 Controlled Transactions

Transactions involving acquisition of control over strategic companies that require the preliminary consent of the Russian Government include the following:

- (i) transactions with shares (participatory interests) of such a company if as a result of such transactions a foreign investor or group of persons acquires:
 - the right to direct or indirect disposal of ten or more percent of the total number of votes at shareholder level - *for companies using federal subsoil plots*;
 - the right to direct or indirect disposal of more than 50 percent of the total number of votes at shareholder level - *for companies engaged in strategic activities other than the use of federal subsoil plots*;
 - the right to appoint (a) the chief executive officer, and/or (b) more than 50 percent of the members of a collective executive body of such a company;
 - the unconditional ability to elect more than 50 percent of the members of the board of directors (supervisory council) or another collective governing body of such company;
- (ii) for companies using federal subsoil plots - transactions aimed at the acquisition by a foreign investor/group of persons of shares (participatory interests) if the foreign investor or group of persons already has (a) the right to direct or indirect disposal of ten or more percent of the total number of votes at shareholder level (that is, any increase in a shareholding in a strategic company), the right to appoint (b) the chief executive officer, and/or (c) ten or more percent of the members of a collective executive body of such a company (d) the unconditional ability to elect more than ten or more percent of the members of the board of directors (supervisory council) or another collective governing body of such company;
- (iii) agreements resulting in the acquisition by a foreign investor or by a group of persons of rights to perform the functions of a management company;

- (iv) other transactions aimed at the acquisition by a foreign investor or group of persons of the right to determine the decisions of the governing bodies of such a company, including the rights to determine its business activities; and/or
- (v) transactions aimed at the acquisition by a *foreign state, international organization or organization controlled by them*, of the right to dispose *directly or indirectly* of more than
 - five percent of the total number of votes at shareholder level - *for companies using federal subsoil plots*; or
 - more than 25 percent of the total number of votes at shareholder level - *for companies engaged in strategic activities other than the use of federal subsoil plots*.

Similar criteria are employed by the Law on Strategic Companies when defining the notion of ‘control’. “Control” denotes not only a certain minimum shareholding level, but also rights to appoint management bodies and otherwise determine the company’s business activity.

Acquisition of five percent or more of the shares (whether voting or not) in any strategic company requires providing a post transaction notification to the Government.

2.1.4 Special Restrictions for Foreign States, International Organizations and Organizations Under Their Control

A foreign state, international organization or organization controlled by them are explicitly prohibited from acquiring control, as defined by the Law on Strategic Companies, over strategic companies. Namely, they are not allowed to acquire:

- (i) ten or more percent of the total number of votes at shareholder level - *for companies using federal subsoil plots*;
- (ii) 50 or more percent of the total number of votes at shareholder level - *for companies engaged in strategic activities other than the use of federal subsoil plots*; or
- (iii) other rights mentioned in items (iii) and (iv) of the above section “controlled transactions”.

2.1.5 Consequences of Violation of the Law on Strategic Companies

Transactions executed in breach of the Law on Strategic Companies are deemed void. The parties to a void transaction may be ordered to return everything received under such transaction in a court action. If it is impossible to reverse a deal, a court may

rule to deprive the foreign investor of voting rights at general shareholders meetings of a strategic company if the foreign investor has not complied with the requirements of the Law on Strategic Companies.

2.3 Special Economic Zones

In 2005, the Federal Law On Special Economic Zones in the Russian Federation No. 116-FZ dated July 22, 2005 (the Law on Special Economic Zones) was passed, which introduced new methods for the provision of investment benefits. Under the Law on Special Economic Zones, a special economic zone (“SEZ”) is a territory in Russia selected by the government on a tender basis from proposals submitted by regional authorities. A special preferential regime for conducting business activities is to be provided for 20 years to encourage development of high technology industrial areas and health and recreational resorts, and for 49 years to develop transport infrastructure (international cargo sea and river ports and airports).

In December 2005 six geographic locations in various parts of Russia were selected by the government for the creation of SEZs of two types - High Technology Incubation Zones (“TIZs”) and Industrial Production Zones (“IPZs”).

TIZs will be located in the Moscow Region (Dubna and Zelenograd), St. Petersburg, and Tomsk - four in total. Each zone will have its own specialization: The TIZ in Dubna will specialize in nuclear technology, energy saving, aerospace and civil engineering; the TIZ in Zelenograd will specialize in microelectronics, nanotechnologies and medical studies; St. Petersburg will specialize in the development and testing of computer programs, databases, and complex equipment; while Tomsk will specialize in the development of new technologies and production of new types of materials, micro- and nanoelectronics.

Two selected territories have been chosen to accommodate IPZs - in the Lipetsk Region and in Yelabuga (Tatarstan). The IPZ in Lipetsk will produce consumer appliances, electronics, machinery and construction materials, while the IPZ in Yelabuga will specialize in components for the automotive and petrochemicals industries.

Another type of SEZ, introduced in late 2006/early 2007 is the Zone of Tourism and Recreation (“ZTR”), which will provide for the development of tourism, and health and recreational resorts. Currently seven projects have been selected for ZTRs, to be located in Altai and Buriatia, the Krasnodarskiy, Stavropolskiy and Altaiskiy Territories, and the Kaliningrad and Irkutsk Regions. They are expected to start operating by 2012 and receive over one million visitors annually.

The Port Zone (“PZ”) type of SEZ was introduced in late 2007. The exact number of PZs to be created has not been decided yet, but three projects were selected in 2008: the port in the Khabarovskiy Territory, and two airports - in the Krasnoyarskiy Territory and the Ulianovskiy Region. It is expected that several other territories also will be selected for international cargo sea/river-port and airport infrastructure development. Residents will engage in load discharging, warehouse services, transportation and forwarding, ship Chandler services, ship maintenance and technical support, wholesale trade, simple assembling, packaging and marking, processing of fish and other sea products, and operation and maintenance of the PZ.

The Federal SEZ Management Agency was created by the Russian Government within the Ministry of Economic Development and Trade (more information on SEZ development is available at www.rosuez and www.rosez.ru). Russian legal entities interested in participating in an SEZ (note - benefits apply to foreign investors only upon the creation of a Russian subsidiary) should obtain the status of an SEZ resident by entering into an agreement on technology implementation activities with an SEZ Administration. The application should be supported by a business plan. A Special SEZ Expert Council (including the SEZ Management Agency, regional and local administration officials, and other SEZ residents and experts) decides on whether the applicant qualifies to be an SEZ resident based on a score evaluation system, taking into account the prior expertise of the applicant (or the founder of the applicant) in the selected industry, calculation of the investment recoupment period, the markets for the developed products, competition and other business risk analysis, intellectual property rights issues, etc. Residents of an IPZ have to invest at least one million euros during the first year of their project and at least ten million overall during the project. PZ residents have to invest 100 million euros if developing new international cargo port infrastructure, 50 million euros if developing a new river-port or airport, and no less than three million euro if reconstructing the infrastructure of existing ports, river-ports or airports.

Residents of SEZs will be provided with the following major tax benefits:

- exemption from Corporate Property Tax, Transport Tax and Land Tax (the latter applicable only to the owners of land plots) for the first five years after a property is acquired;
- a reduced regional portion (13.5%) of the Corporate Profits Tax rate upon the introduction of this benefit in the corresponding Regional Law, resulting in a total Corporate Profits Tax rate of 20% down from the usual 24%; also,

the amended provisions of the Russian Tax Code now allow residents of TIZs, IPZs and even ZTRs to immediately write-off expenditure on scientific research and development works; in addition to that IPZ and ZTR residents will be able to use accelerated amortization for fixed assets, and be able to write-off any losses without limitations, otherwise resulting in a need to carry-forward.

- a Unified Social Tax (UST) on employees' salaries on a regressive scale ranging from 14% down to 2% (usually 26% down to 2%) for TIZs;
- a special "free customs zone" regime for residents of TIZs, IPZs and PZs incorporating the ability to import goods and equipment for the resident company's use with neither import customs duties nor VAT, and the possibility to acquire Russian goods under a 0% export rate of VAT. Services (works) performed by PZ residents will be exempt from VAT. Goods brought into PZs or produced within PZs and exported will be also exempt from excise tax, if it generally may be applicable.

In addition to Special Economic Zones discussed above, ad-hoc legislation on specific free economic zones ("FEZs") was adopted for several regions and is currently still in force. One example of such legislation is the Federal Law On the Special Economic Zone in the Kaliningrad Region of January 10, 2006 (which recently replaced previous legislation of January 22, 1996) and the Federal Law On the Special Economic Zone in the Magadan Region of May 31, 1999.

It is also of note that all gambling businesses will be transferred to four territories (zones) in the Primorskiy, Altaiskiy, and Krasnodarskiy Territories, and the Kaliningrad Region, by July 1, 2009; however, these zones will not provide any special tax benefits.

2.4 Regional Legislation

Prior to investing in a region, and in addition to reviewing the applicable federal legislation, potential investors should also examine regional laws. One of the most distinctive features of the investment climate in Russia has been the competition among various regions of Russia to attract investment, both foreign and Russian. Striving to attract as many investors as possible to their respective territories, and thus improve the social and economic conditions of their regions, the constituent entities of the Russian Federation have passed a large number of laws, regulations, and other legal measures to encourage and regulate investment. Some regions have made special efforts to introduce favorable conditions for foreign investment, while others have enjoyed no success in improving their investment climate.

One of the most progressive regional investment laws was approved in the Leningrad Oblast (region) in 1997. The goal of this law was to develop investment activity in the Leningrad Oblast. To achieve this goal, the law created a “most favorable treatment regime”, and provided additional guarantees of state support to investors involved in investment projects having major economic and social importance for the region. Similarly positive, the city of St. Petersburg recently adopted a number of tax incentives aimed at attracting investment into the production sphere there.

Other pro-investment regions include the Samara, Saratov, Nizhnii Novgorod, Sverdlovsk, Novgorod Oblasts (regions), and the Krasnodar, Perm and Khabarovsk Krai (territories), all of which have attracted significant amounts of foreign capital. Laws providing for certain measures aimed at attracting foreign investors, in particular, reduction of taxation rates for investors, have been adopted in Tyumen, Kaluga, Voronezh, Lipetsk, Kemerovo, Orenburg Oblasts (regions) and in the Republic of Mordovia.

Creation of Special Economic Zones in the Russian Federation may also become a new means of attracting investors. The regulatory framework for these territories is established at both federal and regional levels. Laws providing for tax incentives for residents of Special Economic Zones have already been adopted in the Lipetsk, Moscow, Kaliningrad and Tomsk Oblasts (regions), in the Republic of Tatarstan and in St. Petersburg.