

How to invest IN RUSSIA

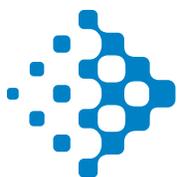


THE AEB'S GUIDE
ON INVESTING IN RUSSIA 2013



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Dear Readers,

Welcome to the 2013 edition of the AEB's "How to Invest in Russia" guide.

Russia has established itself as one of the main foreign investment opportunities for European companies and has shown tremendous development in the recent past. Building on a period of sustained growth since 2009, Russia recently announced a series of strategic objectives to improve its investment climate and to bring it into line with global practice. In 2012, following 19 years of negotiation, Russia joined the World Trade Organisation as its 154th member. Additionally, in the same year it created a common economic space with Belarus and Kazakhstan.

Russia's economy continued to perform relatively well in 2012, with GDP growth at 3.4%. However, recently it has shown some signs of slowing down in the face of the global economic downturn. In the first quarter of 2013 this resulted in GDP growth of just 1% with a Ministry of Economics forecast of 2.4% for the whole year. This slowdown was perhaps inevitable given record low levels of unemployment (5.2% last autumn) and signs of overheating, with inflation last year touching 7%. It should be remembered,

however, that Russia is in the enviable position of having extremely low levels of public debt (11% of GDP), the third highest foreign exchange reserves in the world, at \$528 billion, and a solid trade surplus of \$212 billion.

Over the last year, the Russian government has stated that one of its primary objectives is to improve the foreign investment climate. It has focused on a series of measures aimed at improving the legal environment, cutting down on corruption and moving its position upwards on the international government transparency index. Additionally, it has been seeking ways to diversify its economy away from its traditional reliance on the extractive industries by improving infrastructure and by capitalizing on high technology developments.

Taken overall, the prospects for Russia in 2013 and beyond are promising as the country continues to offer an attractive set of opportunities. But at the same time, investing in Russia remains challenging in terms of project implementation. For these reasons, the AEB publishes this guide which provides valuable information on a regular basis about the latest amendments to Russian legislation, and on the opportunities, advantages and mechanisms of investing in Russia which are available to the foreign

business community and potential investors. The guide demonstrates that sustainable investment in Russia is both possible and worthwhile.

This, the 2013 edition of the "How to Invest in Russia" guide, will bring you the most recent updates on migration legislation, taxation, joint ventures, industry-specific aspects of investing, and investing in the regions. Special attention is paid to the topic of Russia's WTO accession. In addition, this guide gives an inside look at investing in Russia, from the companies' perspectives, and provides examples of successful business initiatives.

We would like to thank all the authors who helped by making their valuable contributions to this guide, and shared their knowledge of the Russian market and their experience of running a business here. Also, we are most grateful to the Ministry of Economic Development of Russia and the Federal Antimonopoly Service who have supported the guide over the years.

We hope this publication will serve its purpose, which is to bring more investment to Russia and to promote a business environment which is beneficial to all interested parties.

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RUSSIA **IS**
THE **RIGHT**
PLACE
FOR
INVESTING
PART I >>

Igor Artemiev
Head, Federal Antimonopoly Service of Russia

LEGISLATION ON FOREIGN INVESTMENTS IN RUSSIA: TOWARDS LIBERALISATION

On 29 April 2008, Federal Law No. 57-FZ “Procedures for Foreign Investments in the Business Entities of Strategic Importance for Russian National Defense and State Security” was adopted. It was designed to filter out speculative financial investments while welcoming long-term foreign investments aimed at developing and improving the Russian economy.

Over a five-year period during which this law has been in effect, the Federal Antimonopoly Service (FAS) received 291 applications.

Of these:

- 159 applications were considered by the Government Commission on Control over

It is worth noting that over the period in question no decision made by the Commission was appealed in court.

The enforcement practice of the Law No. 57-FZ shows that it proved to be effective in protecting the national interests in strategic sectors of the economy.

The state is interested in attracting of foreign investments, including to strategic sectors of the Russian economy. So the state policy in the sphere of control over foreign investments is aimed at creating an attractive investment climate.

In 2011, the Government of the Russian Federation considered and introduced a number of important amendments to the State Duma and the Federal Assembly. The amendments were directed towards simplification of procedures for foreign investors, including investments in strategic areas. Nowadays, the FAS continues working on a reasonable liberalization of legislation, and in April 2013 the Government introduced to the State Duma and the Federal Assembly amendments to Law No. 57-FZ prepared by the FAS Russia for the purpose of eliminating of excessive administrative barriers to foreign investors in executing a deal in relation to companies



The state is interested in attracting of foreign investments, including to strategic sectors of the Russian economy.

Foreign Investments, among them: 151 applications were granted preliminary approval (38 with assignment of liabilities); 8 applications were rejected to be granted a preliminary approval;

- 99 applications were returned to applicants as not requiring a preliminary approval;
- 33 were withdrawn by applicants due to an abandoned intent to carry out a planned transaction;

of strategic importance, as well as adjusting some provisions of the Law No. 57-FZ, particularly for a proper support of the national security interests of the Russian Federation. The basic amendments are as follows:

- Elimination of different interpretations of the current version of the part 7 of Article 2 of the Law No. 57-FZ and establishment of the necessity for a preliminary approval of transaction in relation to a subsurface user



Igor Artemiev

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in a case where the Russian Federation loses its control over such a user (i.e. if before and after the planned transaction, the Russian Federation controls the company, a subsurface user, then there is no need for preliminary approval. If, as a result of a planned transaction, the Russian Federation loses control, then an application shall be submitted for a preliminary approval);

- Elimination of the necessity to agree transactions when the acquirer is an organization that is under the control of the Russian Federation, subjects of the Russian Federation, or citizens

of the Russian Federation who do not have a dual citizenship and are tax residents (this amendment grants an opportunity to make a transaction without granting a preliminary approval to a foreign investor being under the control of a subject of the Russian Federation);

- Amendment of the notion "agreement" (this will be understood as any arrangements and actions of foreign investors on joint voting in management bodies of strategic companies);

- An exception from strategic types of activity the following:

- Activities involving use of infectious agents by companies whose core activity is associated with food production (for the time being, considering the practice of application of Law No. 57-FZ, it is unreasonable to assign the activity on production of cheeses, fermented milk products, juices, bakery products, beer, etc. to strategic types of activity. Therefore,

similar approach for intra-group transactions is established by part 2 of Article 28 of the Federal Law of 26.07.2006 No. 135-FZ "On Protection of Competition");



Law No. 57-FZ defines 42 types of activities that are of strategic importance for country's defence and state security

- Enabling prolongation of the validity period of the previously issued decision on preliminary approval of a transaction (the Government Committee's resolution has an effective period during which a foreign investor may transact a deal. A deal has not been transacted

ing are separate, which is why any amendments proposed should be adjusted and considered from every quarter: as from the point of view of liberalization, so specification of some regulations. It is necessary to find a balance which first of all promotes development. The legislation of the Russian Federation on foreign investments and its enforcement seem to comply with the basic standards and principles of the Organization of Economic Cooperation and Development. Particularly, the principles such as non-discrimination, ensuring of transparency/predictability, comparable regulation and accountability are reflected in Law No. 57-FZ. This is expressed as follows.

This law establishes for foreign investors a unified procedure for the approval of deals as well as requirements and rules restricting participation of foreign investors in the authorized capital stock of strategic companies.



Foreign investors who have already invested resources and put money in Russia will be able to make the necessary re-organizations inside large holdings

this amendment is aimed at freeing companies who use infectious agents (the safest, of pathogenicity grades 3 and 4) in food products. Meanwhile sanitary, epidemiological and medical monitoring is preserved);

- Elimination of the necessity for a preliminary approval for transactions involving foreign investors who own 75% and more of subsurface users' shares as well as of intra-group transactions in relation to such strategic companies (the amendment is aimed at eliminating of bureaucratic barriers. It is of no importance for the RF Government which company of the unified holding's companies bears liability. Foreign investors who have already invested resources and put money in Russia will be able to make the necessary re-organization inside large holdings, which will enhance turnover of capital, escaping the Government Commission. A

in good time for a number of reasons. Currently, the foreign investor must reassemble the package of all documents and re-apply, this process is long and labour-intensive. After adoption of this amendment, in order to prolong the validity period of the resolution made, it will be enough to make a written appeal by the foreign investor stating a substance of the matter and explaining the reason why the transaction is not closed in time;

- Establishment of an obligation for foreign investors to inform about deals approved in advance by the Governmental Committee.

The draft law submitted by the Federal Antimonopoly Service has been prepared under results of social and expert discussion. It is recognized that issues involving the country's defence and state security in the process of foreign investment attract-

According to the legislation, any deal resulting in gaining control over a strategic company by an investor needs preliminary approval after submission of an application to the FAS Russia. The list of transactions that are subject to preliminary approval is established by Law No. 57-FZ.

Regulatory legal acts adopted for implementation of the Law No. 57-FZ (for example, the Rules of Preliminary Approval of Transactions and Approval of Establishment of Control of Foreign Investors or a Group of Persons, which Includes a Foreign Investor, over Economic Associations of Strategic Importance for National Defence and State Security; Exemplary Form of a Business Plan of a Business Society of Strategic Importance Submitted by a Foreign Investor in Accordance with the Requirements of Law No. 57-FZ; Exemplary Form of the Agreement on Ensuring Observation of Obligations by the Foreign Investor or Group of Persons under Investing to Economic Entities of Strategic Importance). These acts are public and available at the official website of the FAS

Russia in Russian and in English. Any regulatory act or amendments to the legislation are drafted after preliminary public discussions in order to find optimal wording of the provisions. When amendments to the legislation are adopted, the FAS hold activities to explain all new provisions.

tors under Investing to Economic Entities of Strategic Importance, and sanctions for non-compliance with the legislative requirements. According to Russian law, no commercial information provided in connection with an application may be disclosed to third parties.

strategic within the meaning of the Law No. 57-FZ.

It is especially noteworthy that decision on preliminary approval of a transaction under application of a foreign investor or on rejection of approval is made at the session of the Governmental Commission headed by the Prime Minister of the Russian Federation. It means that decisions taken are put at a high level and public availability of the relevant information on these decisions.

Thus, it may be stated that all legal regulators of control over foreign investments in strategic economic entities are used, and the existing verification regime of control over foreign investments in such economic entities is a liberal enough. This is confirmed by the small number of proposed transactions which are rejected.



According to the legislation, any deal resulting in gaining control over a strategic company by an investor needs preliminary approval after submission of an application to the FAS Russia.

In order to provide transparency for procedural issues, the Law No. 57-FZ defines a list of strategic types of activity, the procedure for submission and consideration of applications on the part of foreign inves-

Law No. 57-FZ defines 42 types of activities that are of strategic importance for country's defence and state security. This list is closed. This fact enables planning of foreign investments in the areas that are not



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POSITIVE OUTLOOK FOR RUSSIAN INWARD INVESTMENT

Despite the global economic uncertainty, investors remain positive about the long-term attractiveness of Russia as an investment destination, according to Ernst & Young's second Russia attractiveness survey.

The report combines an analysis of international investment in Russia over the last year with a survey of more than 200 international executives on their views about how and where global investment will take place in the next 10 years. Russia's natural resources, growing domestic consumer market, strong labour force and recent accession to the World Trade Organization (WTO) make it an investment destination of choice over the next decade. Although concerns remain around bureaucracy and infrastructure, a large majority of investors believe that Russia has made progress in closing the gap with other rapid-growth markets. The country's attractiveness has grown by eight percentage points since 2011, the largest increase of any region.

According to Ernst & Young's European Investment Monitor project, the number of projects has increased by over 50% in the last decade with 83 foreign direct investment (FDI) projects recorded in 2002 increasing to 128 in 2012. Russia also remains in the top 10 investment destinations in Europe, coming in seventh, and is the premier destination for investment in Central and Eastern Europe.

Investors already present in Russia continue to demonstrate their confidence in the

Russian market. Nearly 80% of them plan to increase or maintain their operations in the country. However, there is a wide gap in plans between the companies that already have operations in Russia and those that are not yet established. Seventy percent of the companies that are not established in Russia have no plans to invest in the country in the next year. This is, however, 16 percentage points lower than 2011, signalling an improvement in potential investors' perceptions of the Russian economy as an investment destination.

Russia has proven resilient, experiencing growth in 2011 and 2012. A boost in consumption, a strong labour market and an increase in investments have been the primary drivers of this growth. However, Russia is facing the challenges of increasing global competition in which investment and technology play crucial roles in diversification and creating sustainable growth.

Where has investment come from?

The US remains Russia's primary investor with 122 FDI projects between 2007 and 2011 (16% of the total), but 8 of the top 10 source countries are from Europe. European countries established 343 FDI projects in Russia from 2007 to 2011, 44% of the total. Germany emerged as the second-largest investor globally with 99 FDI projects followed in third place by the UK with 46 projects. Other leading investing countries from Europe include France and Finland, with 45 and 43 projects, respectively.

Following Russia's recent accession to the WTO, Russian policymakers should push toward attracting a larger share of investment from its leading source regions such as the US and Europe.

FDI into Russia from emerging market countries remained low between 2007 and 2011. India and China each accounted for less than 2% of FDI projects in Russia. Just two projects originated in Brazil. These countries



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remained minor contributors on the employment generation front too.

However, Russia has recently started negotiations with China to develop a mutually beneficial investment climate.

Manufacturing at the heart of Russia's attractiveness

Manufacturing activity remains at the heart of Russia's attractiveness, accounting for 51% of investment projects and 92% of job creation between 2007 and 2011. The industrial sector was another high performer, with automotive attracting 90 projects, and machinery and equipment recording 62 projects. The food sector brought in the second-largest number of projects (86) and business services also witnessed a marked growth in FDI.

FDI activity in Russia's business services sector has been growing in recent years. It

accounted for 9% of the total FDI projects in 2011, higher than its 5% share in 2010 and above its average of 6% between 2007 and 2011. When financial services and the software industry are included in the business services category, this figure increases to 14% of the projects between 2007 and 2011, compared with the automotive industry's 12%.

Nearly 39% of investors expect the mining and oil and gas sectors to attract the most FDI in the next two years. Information and communication technologies (ICT) was named second-most often by investors (20%), followed by energy and utilities, agriculture, consumer goods and automotive. The country's focus on oil and gas creates a large mismatch between the attention that other strategic industries in Russia receive from investors and their real potential.

Russia's domestic market is its key strength

In this year's survey investors highlight Russia's domestic market (74%) as its key strength. As a result of rising wealth levels over the past decade, 25% of Russia's population is now part of the "middle class". And this percentage is growing. Education (65%), telecommunications infrastructure (64%), labour costs (61%) and skills (57%) are also recognized as some of Russia's most attractive features.

Although a majority (57%) of investors remain optimistic about Russia's attractiveness in the medium term, the level of confidence has waned slightly since last year. Investors remain concerned about Russia's political, legislative and administrative environment (62%); its transport and logistics infrastructure (44%); and limited incentives for sustainable development.

However, investors already present in Russia have more confidence in its economy. First, they like Russia more because they under-

stand the market better and are aware of the elements that make the country attractive. Second, investors have already crossed the preliminary hurdles to enter the Russian market.

Outlook

Despite the wave of negativity arising from the Eurozone crisis, investors continue to display confidence in the Russian market and optimism about the future. Russia's numbers are very positive compared with Europe as a whole. In Ernst & Young's 2012

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As a result of rising wealth levels over the past decade, 25% of Russia's population is now part of the "middle class", and this percentage is growing

European attractiveness survey 38% of respondents said they believe the continent's attractiveness will improve, while a similar percentage believe that it will remain the same.

While the Russian economy will be affected by the crisis in Europe, the effect will be modest compared with other European economies. However, Russia's accession to the WTO as well as the 2012 Asia-Pac Economic Cooperation (APEC) summit, the 2014 Winter Olympic Games and the 2018 FIFA World Cup are helping position the country as even more attractive for foreign investment.

How WTO access adds to the investment attractiveness

Ernst & Young's survey Russia's success in the WTO: What The Opportunities?, published

in 2012, gives an assessment of the consequences of Russia's accession to the WTO in relation to the entire country's economy and shows that it should have a positive effect. The overall effect of both the change in tariff rates and the improvement in conditions for Russian manufacturers' access to foreign markets will in the short term be 0.5% of the level of aggregate consumption in the country.

How can WTO access add to the country's investment attractiveness? It is necessary to increase the potential of Russian non-raw-material exports by reducing the obstacles to Russian companies' entry into foreign markets and to take steps to support exports which are not banned within the WTO. The experience gained by China and a few other exporting countries shows that an export-promoting policy provides good opportunities for development. The accession of Russia to the WTO now enables the country to use that mechanism to promote development. The issue is not direct measures of state financial support for exports as the WTO bans the use of most of these measures. However, the exporters' costs are due to other factors (informational, licensing, customs, administrative, infrastructural, etc.), in relation to which the WTO does not restrict state support measures, but, on the contrary, even encourages them.

Russia's accession to the WTO is having a positive effect due to the growth of foreign direct investment in the country. The experience of countries which acceded to the WTO earlier and the assessment of the consequences of Russia's accession to that organization show that foreign direct investment in the liberalized service sector may eventually mean the growth of production in the country by up to 11% of GDP. To enhance that effect, the authorities at all levels should regard the improvement of the investment climate as the economic policy's key priority.

Art Franczek
Institute of Business and Economics

PERIOD OF ADJUSTMENT: HOW RUSSIA IS ADAPTING TO THE WTO AND WHAT IT MEANS FOR INVESTORS

After 19 excruciating years of negotiations, Russia has finally become a member of the World Trade Organization. The hopes and expectations of this event are quickly evolving into political and economic realities as Russia adjusts to the new and sometimes shocking rules governing the main aspects of international trade and domestic economics.

The World Trade Organization has a framework for trade policies for its member countries. It was established in 1995 as a replacement for GATT. The 156 countries belonging to WTO that represent 93% of world trade. Some of the main principles of the WTO are:

- Liberalization of trade and the elimination of trade barriers
- The principle of ongoing negotiations
- Most-favoured-nation regime
- National treatment
- Freer Trade
- Predictability and Transparency
- Promotion of fair competition
- Dispute settlement on an interstate level.

Some Russian commitments under WTO are:

- On average the final binding tariff rate will be 7.8 % (previous rate was 10%)
- For agriculture products the rate is 10.8 % (previous rate was 13.2%)
- For manufactured goods the rate is 7.3% (previous rate was 9.5%)

- The final bound rate was implemented on the date of accession for more than one third of the national tariff lines. Another one fourth will be put in place after three years. The longest implementation is 8 years for pork, followed by 7 years for autos and civil aircraft.

The World Investment Report estimates that more than 40% of Russia's GDP comes from the services sector. Liberalization as a result of Russia's WTO agreements will gradually open the country's service market to foreign investors. Russia has undertaken special obligations in 11 service industries and 116 sub-industries. For example:

- In banking: foreign banks may now establish majority-owned affiliates, and the threshold of foreign participation has been raised to 50% (with the exception of foreign investment in privatised banks, in which greater ownership is allowed). Branches of foreign banks are still not allowed, but this issue will be reviewed in the future.
- In insurance: the share of foreign ownership has been increased to 100% of non-life insurance companies and 50% in life insurance. Foreign majority ownership will be allowed after 4 years. Previously, foreign ownership was allowed at 15% for both life and non-life companies.
- In business services: the country has committed to allowing market access and national treatment for a wide variety of professions. Foreign companies have been permitted to operate as 100% foreign-owned entities.



The World Bank estimates that Russia should gain about 3.3% annually in GDP in the short term, and 11% in the long term as a result of WTO accession

- In telecommunications: restrictions of the 49% foreign participation will be eliminated within four years.

and lower prices of services that lead to productivity increases and increased competitiveness of Russian firms using these better



Art Franczek

Art is the president of the American Institute of Business and Economics in Moscow (an English language MBA program founded in 1989). He holds degrees in History and Political Science in addition to an MBA, CPA and a Master's in 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 and the World Bank. He has also written many articles on IFRS, Customs and Taxation issues, in addition to a book on IFRS.

- In distribution services: 100% foreign-owned companies have been allowed to engage in wholesale, retail and franchise activities, as well as express delivery services, including the distribution of pharmaceuticals.

The World Bank estimates that Russia should gain about 3.3% annually in GDP in the short term, and 11% in the long term as a result of WTO accession. In a recent report the World Bank states: "About 72% of the estimated gains come from improved quality

services. Crucially, firms and consumers will have access to more and better services from increased FDI in business services. Increased productivity means that real wages should increase and prices should decline, benefiting consumers and lowering the cost of production for firms."

It should be noted that this World Bank study was prepared in 2007.

Maxim Medvedkov has said the Russia's accession to WTO may actually cause a decrease in GDP of 0.5% due to some Gazprom issues. Prime Minister Medvedev said that Russia may not realize results for 5 to 10 years.

Analysts say that Russia's accession to the WTO will have a positive impact on EU trade. EU companies are estimated to save 2.5 billion Euros annually on reduced import duties with Russia. Also it is estimated that the reduced tariffs will stimulate an additional 3.9 billion Euros in EU exports to Russia. The main exports of the EU to Russia are cars, auto parts, medicines, telephones and tractors.

Poland has already reaped some benefits from Russia's WTO accession as its agricultural exports to Russia increased 30% in October of 2012 as a result of reduced tariffs. Pork and meat exports to Russia from the EU increased 37% in Oct 2012 from the previous year also a result of Russia's reduced import tariffs. EU pharmaceutical companies such as Bayer are positioned to increase exports to Russia because of reduced tariffs, improved IPR because Russia has joined TRIPS and the applicability of the data exclusivity law.

The IT industry will significantly benefit from WTO accession as Russia has removed restrictions on imported (cryptographic) equipment and has also removed import duties on high-tech goods. IT spending in Russia is expected to increase by 11% in

2013. This should benefit companies like Nokia, Phillips and Siemens.

Foreign investment in the automotive industry has been especially strong. It has been spurred by government regulations requiring foreign companies to increase local content of their vehicles to avoid stiff import tariffs on automotive parts, as well as by the recovery of car sales. General Motors announced in August 2012 that it would invest one billion dollars in the next five years to expand capacity at its three manufacturing facilities in Russia. In May 2012, a Franco-Japanese alliance between Renault and Nissan increased the companies' commitment to the Russian market by agreeing to spend \$750 million on a controlling stake in AvtoVAZ. In another major investment, Fiat plans to finalize a deal to spend 850 million Euros in a new factory near St. Petersburg, with a capacity to build 120,000 vehicles annually. A strong incentive for these invest-

ment networks, boosting capacity, or making acquisitions. International Paper is investing more than \$1.2 billion to modernize plants. Caterpillar's CEO, Doug Oberhelman, says Russia could become the company's No 1 export market. In 2012 sales in Russia were 27% higher than the previous year. Clearly Russia's WTO accession has generated increased interest in investing in Russia.

According to official estimates Russia will lose \$5.7 billion in revenue in 2013 and \$7.8 billion in 2014 as a result of the reduced tariffs WTO requires. Some Russian industries are already reporting the negative effect of Russia's WTO accession. For example, GAZ estimates losses of about \$120 million in 2013 and 2014 because of increased competition from foreign producers of commercial vehicles. Russian sales of combine harvesters declined 43% in 2012 and protective measures for this industry are being discussed. The price of domestically-produced



Analysts say that Russia's accession to WTO will have a positive impact on EU trade

ments was Russia's WTO agreement that extended the local content tariff benefits until 2018.

Boeing has announced plans to sell 35 of its 737-MAX planes to Russian Technologies, a state-owned defence company for \$3.5 billion. The first delivery of these planes is to take place in 2018 when the tariff on civil aircraft is reduced from 20% to 7.5% saving the company about \$440 million in import tariffs. This kind of cost optimisation is a major incentive for investors who are closely examining the schedule of reduced tariffs under Russia's WTO agreement.

Expecting increased demand following WTO entry, International Paper Co, Caterpillar Inc, Deere & Co and others are stepping up investment in Russia by expanding distri-

butions. The price of chicken has decreased 20% in 2012, and the price of pork has decreased 30% since Russia's accession to WTO. The New Economic School reports that the so-called "monogorods", which are a legacy from the Soviet era, are severely exposed to WTO changes. Russia has 450 of these monogorods which are at risk of a serious economic downturn if the specific industry on which they depend suffers a loss in market share or profitability. This could create severe unemployment and social unrest.

The WTO allows Russia to continue subsidy payments to negatively affected industries. There are two categories of price supports. The yellow subsidies are considered to be trade distorting and include payments based on the size of agricultural plots, payments based on the number of farm animals, sub-

sidized loans and other subsidies. The limit on agricultural subsidies is \$9 billion for 2013 but declines to \$4.4 billion by 2018. In 2008 Russia paid about \$6.5 billion in subsidies. Green subsidies have no limit and include such items as training, research, payments under environmental programs, investment aid and others. A top priority for the Russian government is to minimize the negative effects of the WTO on its industries while encouraging the positive effects of increased foreign investment. The loss of budget revenue is a serious concern as revenues from import and customs duties are about 37% of total revenues. This could cause customs officials to adopt a more aggressive position in collecting customs duties.

- Russia has banned the import of live pigs from the EU. Under the Phyto-Sanitary provisions of Russia's WTO agreement Russia must provide a scientific basis for this ban.
- Russia has banned the import of meat and pork from the United States because US meat producers use ractopamine (a meat additive). The Codex Alimentarius Commission (authoritative body for SPS under the WTO) has determined that this additive is safe.
- Russia has banned the import of chilled meats from Germany also because its producers use ractopamine.
- Russia is also considering the use of WTO dispute resolution in the following areas:
- The EU is currently filing an antitrust case

Russia's WTO accession ushers in a new economic age for Russia as President Putin has said: "Russia's accession to the WTO will create the incentive required to modernize our economy, improve our business climate, help Russia in the medium term to gain a better place in the international division of labour, and make our market more attractive to capital and direct investments."

For detailed information on WTO please look at:
www.wto.org,
www.economy.gov.ru/minec/activity/sections/foreignEconomicactivity



The WTO Dispute Resolution Understanding (DRU) is one of the primary tools that investors have available to protect their investments

Dispute Resolution under the WTO consists of four steps, Consultations (60 days), Consideration of the Complaint by a Panel (9 months), Appellation Procedure (60 days) and Implementation of the DRU decision (15 months). Since Russia became a member of the WTO, the EU and the US have considered using the WTO dispute resolution system in the following areas:

- Russia's implementation of a recycling tax on imported cars. This tax was enacted to make up for the loss of revenue because of the reduced import duties on cars. Although applying this tax to Russian producers has been discussed, the tax is still unchanged and is considered discriminatory against autos imported from the EU and the US.
- Russia has refused to abolish Siberian overflight charges for European carriers. Although the removal of these fees was an essential part of Russia's WTO agreement, Russia is still charging about 400 million Euros a year to European carriers. These fees are potentially discriminatory and are currently being discussed.

against Gazprom for impeding competition and manipulating gas prices. Several officials in Russia take the position that the EU is discriminating against Russia and is therefore in violation of WTO rules.

- According to the Ministry of Economic Development, 73 trade barriers are currently imposed on Russian goods in 18 foreign markets. These cases mainly involve anti-dumping issues. It is estimated that Russia loses about \$2.5 billion annually because of anti-dumping issues.

The WTO Dispute Resolution Understanding (DRU) is one of the primary tools that investors have available to protect their investments. Also, Russia is able to use DRU as a tool to protect its economic interest. Trade disputes are a normal part of WTO and in past years there have been many disputes between the US and the EU, the US and China etc. The decisions and implementation procedures of DRU are highly effective and respected by WTO members.

Alexander Demidov

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Alexander Demidov



Yulia Stetsenko

STRATEGIES AND PROSPECTS OF EUROPEAN COMPANIES IN RUSSIA

The results of the Association of European Businesses and the International Institute of Market and Social Research GfK Rus annual joint survey

In April 2013 the Association of European Businesses (AEB), together with the International Institute of Market and Social Research, GfK Rus, conducted a regular annual survey of AEB member companies in Russia. The survey is conducted for the sixth time and it provides a valuable source of first-hand information, giving an overview of the attractiveness of the investment climate in Russia from the point of view of companies doing business here and focuses on their key problems and strategies.

The survey was conducted via online and paper interviews with top managers of AEB member companies operating in Russia. The sample of 87 represents the structure of the AEB membership by country of origin and industry. In 2013 a higher proportion of the companies participating in the survey than last year were Russian (29%), though most of them have a share of European capital and/or were founded by Europeans. The second-largest national group was German (13%) and, third, French (11%). In terms

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of industries, the companies are various, with the most significant shares, of 18% and 13% respectively, representing professional and financial services. Judging from the number of the employees and the turnover we conclude that an average participant of the survey is a middle-sized company with fewer than 100 employees in Russia and a turnover less than EUR 100 million. In 2013 more companies name lower levels of competition, favourable prices for raw materials, lower wages and state incentives as the main reasons for their entrance to the Russian market, although the most significant reasons still are high market potential and size, and the positive market development.

The study's primary objective is to estimate the current economic situation in Russia and, more precisely, the prospects for companies and industries. The second section of the study covers investments and the ease of entry to the Russian mar-

ket. The top managers also estimate the financial aspects of their activities in Russia, as well as the local business culture, the business environment and obstacles for development. In the 2013 survey we included additional questions on the results of the parliamentary and presidential elections in Russia, influence of Russian WTO membership and the European economic crisis.

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The main results of the survey show that due to the slowdown of the growth in the Russian economy and the influence of the crisis in Europe, the top managers of the companies operating in Russia are less positive towards the current state of their business in Russia and the future than last year. The integrated AEB and GfK Rus Barometer Index¹, which consists

¹ The Index is the difference between positive and negative answers on the scale of 200 points. In case of only negative answers the Index will be equal to 0, in case of only positive - to 200. If the share of positive and negative answers is equal, the Index is 100. Positive value is between 100 and 200, negative— below 100.

AEB-GfK-Barometer: Positive Expectations for Business in Russia

Integrated index

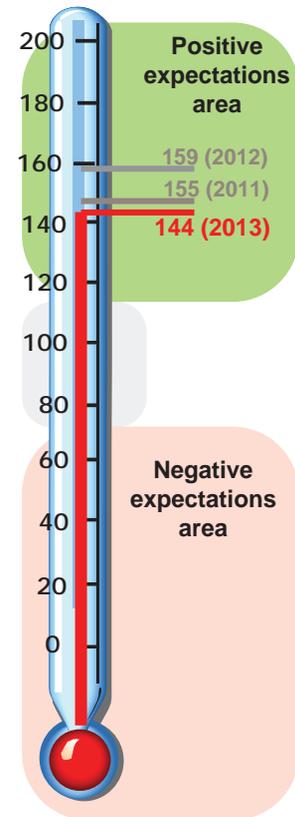


- Single Index**
- Current business situation (I=169)
 - Current macroeconomic situation (I=87)
 - Business development index (I=92)



- Single Index**
- Business expectations(I=160)
 - Short term expectation index(I=137)
 - Mid term expectation index(I=145)
 - Long term expectation index(I=150)
 - Turnover expectation index(I=187)
 - Profit expectation index(I=170)

AEB-GfK Index, 2013



of an Index of the Current State of Business and an Index of Expectations, is 15 points lower than in 2012, standing at 144 points out of 200. Nevertheless the integrated Index is still in the positive area.

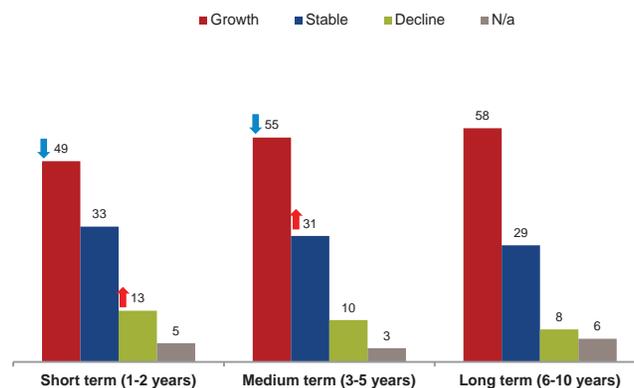
The participants of the survey reveal that the development of their business in the first quarter of 2013 was worse than they

had expected. This will result in a relative down-turn in investments, both in their industries and in the country as a whole.

The trend for positive expectations for the future still remains with the Index of Expectations (158 points) far above the Index of the Current State of Business (116 points).

2013 did not start auspiciously for the Russian economy. In the first quarter, the dynamics of such data as the index of industrial production and real income per capita were lower in comparison to the same period of the previous years, leaving less room for positive expectations, at least in the short-term.

The Economic Outlook for Russia over the Next 10 Years, %



↑↓ Significant increase/decrease compared to the previous metering in 2012

Base = 87 AEB members (2013)
86 AEB members(2012),
105 AEB members(2011)

Against the background of the economic crisis in Europe and the slowdown of the development in Russia, we registered a drop in the short- and medium-term expectations (1-5 years) for the development of the Russian economy. Still, taking the long view, top managers of AEB member companies operating in Russia still expect strong growth.

The companies are also optimistic about the turnover and the margins of their operations. Although fewer companies this year report turnover increases than in the previous years (78% against 87% in 2012) and despite the moderate start to the year, companies expect turnover and margin growth in the next three years.

It is notable how the estimates of WTO access for Russia have changed during the past year. Before Russia entered the World Trade Organization, most of the survey participants considered this prospect as a positive one for the Russian economy. A year later, after Russia had accessed the WTO, most companies (66%) did not register any impact of this fact on their business. The impact that 50% of companies register is that of the European economic crisis.

The financial environment for AEB members' businesses is quite acceptable. Normally, less than 20% of payments are overdue, with about 50% of overdue payments being no more than a month late. 32% of compa-

nies have never had "bad debts". 40% of the companies participating in the survey went to court in order to collect debts, and almost all won their case. As in the previous years, the main problems for financing are high interest rates, lack of financing and limits on bank loans. It is worth mentioning that, in comparison to last year, the participants of the survey noted fewer limitations from the side of the banks. For example, in 2012, 40% of companies considered high credit rates as one of the main obstacles for borrowing from banks, whereas in 2013 only 25% did. Moreover, fewer participants mention limitations in giving out loans and the limited number of the financial instruments that the Russian banks offer.

The trend for low estimates of the Russian business environment that survey participants noted in previous years remains. They are quite negative about the interaction with state authorities, especially the customs and the tax authorities. Legislative restrictions are the main obstacles for production.

Most participants in the survey don't expect any positive changes in terms of bureaucracy and corruption in the next two years. On the other hand, they expect some positive changes in the customs rules and business legislative regulations, which is new in comparison with previous years' surveys.

The second most regularly mentioned obstacle for business development, after leg-

islative restrictions, is the lack of qualified personnel. Rising labour costs worry the respondents. In 2013 fewer top managers expect an improvement in labour cost. The optimism that they expressed on this issue in previous years is vanishing.

Summing up, it is necessary to say that the AEB-GfK survey in 2013 shows an interesting dynamic. On the one hand, AEB companies operating in Russia came across some difficulties in the first quarter of 2013 caused by the European economic crisis and the slowdown of the growth of the Russian economy. They expect to make less investment this year; there is a decline in the expectations for industries and for Russia in the short and medium terms. On the other hand, the expectations for the long term are still very positive. Successful business development is still severely hampered by high levels of bureaucracy, corruption, inefficiency within state institutions and the lack of a qualified workforce. It will be interesting to see how the perception of their business activities and the investment climate in Russia responds to the challenges of macroeconomic and social circumstances.

BEFORE
YOU
START
PART II >>

Maxim Novikov

Senior HR Manager,
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THE IMPORTANCE OF TAKING MIGRATION ISSUES INTO ACCOUNT WHEN PLANNING INVESTMENTS IN RUSSIA

Foreign investors coming to, or operating in, Russia need to bear in mind various issues, including financial and tax planning, compliance with Russian legislation, market development, the need to adapt to changing conditions, and so on.

Clearly, a company's business development depends heavily on its people, as one of its main assets. In developing the market and adopting best practices, foreign investors often need experienced and highly professional foreign specialists willing to share their knowledge with Russian staff.

In addition, senior management faces the strategic task of implementing their company's values and corporate culture within the framework of leading international standards. The progress of investment plans can be seriously compromised without the expertise and involvement of foreign staff.

In most cases, expatriates bring their families with them, to make their move to a new country and environment as smooth and comfortable as possible. To avoid problems with such issues, it is important to know the principles and basic requirements of Russian migration law.

Over the past twenty years, migration law has changed significantly in terms of both

the regulations and the liabilities of the parties involved. This trend can be attributed to Russia's economic growth, which has led to an improvement in the investment climate and to positive developments in inter-governmental relations.

These factors have had a significant influence on the development of migration policy and the creation of more relaxed conditions for foreigners coming to work in Russia. For example, special regulations for highly qualified specialists (HQS) offer a fast-track process for Russian employers hiring such expatriates, as well as attractive personal tax rates and other advantages, thus making it easier to hire foreigners.

The other side of Russian immigration policy involves maintaining a reasonable balance between foreign and Russian employees on the Russian labour market, to protect the interests of Russian citizens. As a result, an annual work and residential permit quota is used to maintain this balance.

Investors should bear these issues in mind to ensure that foreign specialists and their family members arrive in Russia at the



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In March 2013, Maxim was elected Deputy Chair of the AEB Migration Committee. Maxim graduated from Moscow Law University (in accounting & audit) and Moscow State Linguistic University (in intercultural communications) and is a Certified Customs Specialist.

employer, which can adversely affect both the company's financial position and its market



The progress of investment plans can be seriously compromised without the expertise and involvement of foreign staff

appropriate time, otherwise, their company's plans may not be implemented on schedule.

Companies should also remember to comply with ongoing requirements such as meeting deadlines for notifying authorities when hiring expatriates, or terminating employment contracts with them. Failure to meet such deadlines can result in substantial fines and penalties for the local em-

reputation and, hence, lead to a decrease in trust from business partners.

A crucial migration issue for expatriates in Russia is the extension of their work permits and visas. Failure to complete these procedures on time is likely to have a negative impact on their next visit. With parents having to leave Russia for an uncertain time, the children's education can be interrupted, and families can be forced to urgently search

for lodging in their home country until the issues are resolved. Such cases cause enormous stress for everyone involved.

Accordingly, the local employer should plan carefully the business and travel plans of people who are so important to an investor's

stay of foreign citizens in the Russian Federation" (hereinafter—"The Law") and the Russian Code of Administrative Offences (hereinafter—"The Code") forbid foreign nationals without a work permit and work visa from engaging in any employment activities.

Generally speaking, obtaining Russian work permits and work visa requires concluding a Russian employment contract.

Expatriates may not be satisfied with this approach if this employment structure influences their home country's social security or benefits programs. In this connection employers should take action in advance to settle such issues. It should be also mentioned that the Law does allow certain categories of foreign nationals to work without work permits. Representatives of the Russian inviting company should study the corresponding list carefully in order to classify individuals in compliance with the Law.

Therefore, investors interested in doing business in Russia need to seriously consider the migration regulations, especially given changing conditions, in order to hire the qualified foreign specialists they need to implement their investment plans.



It is important to know the principles of Russian migration law

business in Russia. To ensure that all the migration procedures comply with legislation and to avoid any negative consequences from failing to obtain or extend expatriates' documents on time, the local employers have to ensure that they deal with these issues internally or turn to the services of professional consulting companies in order to feel more confident in the face of changing conditions.

Another part of a foreign investor's business can be sending foreign specialists to Russia on a short-term basis, from several days to several months. The usual purpose of such visits is meetings with potential or current business partners, clients or local staff to discuss business development, or to conduct "quality performance reviews" to ensure that the company's strategic plans and progress in implementation are in line with global objectives.

In many cases, however, staff can be seconded either to share knowledge with their Russian colleagues or to participate in joint client projects. Investors see this as part of the implementation of their local market expansion plan. In practice, host companies in Russia arrange business visa support for the above purposes.

The question remains about how Russian migration law, and the migration authorities in particular, approach the activities of foreign nationals staying under business visa regimes. Both the Federal Law "On the legal

The Code treats any form of work or service provision as an employment activity. If the authorities discover that a foreigner staying in Russia on a non-work visa has performed work or provided services (even free of charge), the inviting company may be faced with considerable fines and penalties, and the foreigner may be subject to serious administrative sanctions, including deportation.

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HIRING FOREIGN SPECIALISTS WHEN PLANNING INVESTMENTS IN RUSSIA: WHAT TO REMEMBER

Russian migration policy traditionally aims to satisfy two opposing purposes.

The first one is that the Russian government is improving the existing migration rules, developing new migration instruments that aim to encourage skilled foreign professionals to come to Russia and not curtail inflow of investments into the economy. In recent years, Russia has developed a number of effective migration instruments that allow foreign employees to be brought to Russia rather quickly. For example, a simplified procedure for obtaining migration employment permission for highly qualified foreign

gration regime for investors from the WTO countries. Thus, currently the State Duma (the Lower Chamber of the Russian parliament) is considering a draft law establishing special rules for key personnel of corporate investors from the WTO countries.

On the other hand, the Russian authorities are trying to protect the Russian domestic labour market and prevent illegal immigration. For this purpose they use different legal mechanisms. For example, they establish legal requirements and procedures that should be observed by companies when hiring foreign employees, as well as setting measures of liability, including severe financial penalties, for those who do not observe the relevant procedures and requirements.

Thus, along with the simplified rules and procedures for obtaining migration permission that are necessary for a foreign national specialist to work in Russia (i.e. a work permit and a work visa³) there is also a regular procedure for obtaining such migration permissions. This procedure has been in effect since 15 January 2007, and is rather complicated and time-consuming. It includes several consecutive steps that should be



In recent years, Russia has developed a number of effective migration instruments that allow foreign employees to be brought to Russia rather quickly

specialists¹ has been introduced. In addition, Russia has signed several bilateral treaties with other states that also establish simplified rules for citizens of such states who wish to work in Russia². Additionally, as Russia has joined the World Trade Organization (WTO), the government is now developing new instruments aimed at improving the investment climate, including simplifying the mi-

completed within a period provided for by law. Generally, the procedure takes around four months to complete, not taking into account the very first step, which is obtaining a

¹ The main criterion for a foreign employee to qualify as a highly qualified foreign specialist is a salary level payable to him/her in Russia, which, as a general rule, should be at least 2 million roubles per year (365 calendar days).

² For example a bilateral treaty with France, dated 27 November 2009; a bilateral treaty with the South Korea, dated 10 November 2010.

³ A work permit is a document that allows a foreign employee to legally exercise his/her job duties inside Russia; a work visa is a document that allows a foreign employee to enter Russia for work purposes (a visa should be presented at the border control).



Victoria Kushner

Victoria specialises in labour and migration law. She provides full legal support to clients on all aspects of foreign nationals' employment in Russia, and on all employment law matters during M&A transactions, company formations and liquidations. In addition, Victoria represents clients during state audits by labour and migration authorities and in employment-related disputes, including with foreign employees. In 2012 she was appointed as a Deputy Chairwoman of the AEB's Migration Committee in Moscow. Victoria graduated from the Moscow State Academy of Law. Before joining the Pepeliaev Group she was an associate at a well-known international law firm, focusing on employment and migration law. In addition to Russian, Victoria also speaks English and German.

quota for hiring foreign national employees. That involves a separate procedure taking about a year.

This aspect should be taken into account when companies plan investments. Bringing foreign national specialists should be carefully planned and may become one of the important milestones in starting business operations in Russia.

Importantly, granting quotas for hiring foreign national specialists is one of the measures aimed at protecting the domestic

labour market and at providing a balance between human resources in the Russian regions. The quota is limited at both levels, at Federal level and at the level of each Russian Region. The limits of the quota are set according to two major criteria: the number of foreign national specialists and the nature or level of their professions/qualifications.

Thus, generally, to be able to obtain migration permissions for foreign national specialists under the regular procedure, the employing entity in Russia should first obtain a quota for hiring foreign specialists. Having such a quota is a mandatory preliminary condition for filling most job positions for which employers plan to obtain employment permits under the regular migration procedure. This requirement applies when an employing entity in Russia plans to hire foreign national specialists to perform employment duties under employment agree-

ments, as well as under civil law contracts (i.e. as contractors providing services).

In accordance with the current quota rules, employers should file a quota application for the next year with an authorized state authority between 1 January and 30 April of the current year.

Notably, for several years, only existing entities could participate in the quota setting under the above rule. Companies that were created after 30 April of a current year could not file quota applications for the year in which they were created, as well as for the next year, which seriously hindered their business operations, as they could not hire foreign specialists under the regular procedure for two years (i.e. in the year when the company was created and next year, as the company was not able to timely file an application).

Therefore, after extensive discussions with representatives of foreign businesses in Russia this rule has been changed. Now, along with initial quota applications for the next year companies may file additional "corrective" quota applications for the current year. That is to say that a company that was created after 30 April will be able to file a quota application next year, as a "corrective" application. However the deadline for filing these applications is the same: before 30 April of a relevant year.

To file the application, employers should take the following main steps :

- register their company at the site www.migravota.gov.ru;
- complete an electronic application at the site;
- print out two copies of the completed application;
- send the printed application to the prop-



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er authority of the constituent entity of the Russian Federation where it is proposed that foreign nationals will undertake employment activity.

As mentioned above, filing the application in good time is a necessary condition precedent to ensure that a quota may be obtained and subsequently to receive migration permis-

ing breaches of the Russian labour law that were discovered by the State Labour Inspectorate in the current year and in the previous years;

- it being impossible to provide foreign employees with accommodation in the locations where employers plan to hire foreign employees.

tion, an employer should give the following information regarding foreign employees they plan to hire next year:

- job position titles⁴;
- the number of employees for each job position;
- the citizenship of each foreign national employee.

Thus, an employer needs to know such data well in advance. Unfortunately, this is not always possible in practice, as business needs change.

Thus, as is seen from the above, the regular procedure for hiring foreign national employees and, in particular, the first part relating to obtaining a quota, is rather complicated. Additional administrative and/or financial resources may be required to make the necessary estimates and plans. In some cases it may appear rather unreasonable to obtain migration permits under the regular migration procedure for hiring foreign national specialists owing to the time necessary to obtain such permits and the high cost that compliance with migration rules and requirements may entail.

For this reason, when companies plan investments which involve bringing foreign specialists to Russia, we recommend that along with the regular procedure for obtaining migration permissions they consider alternative migration instruments, where the quota requirement does not apply.



In addition, an employer has the right to challenge any negative decision regarding the quota if they consider that such a decision is incorrect

sions for foreign employees to be hired in Russia in the calendar year in question. However, regrettably, even if a company participates in the quota campaign, this does not guarantee that quotas will be granted and, as a result, that migration permits to hire foreign national employees for relevant job positions will be issued. The reasons for this are the following.

When making a decision on granting the quota, an authorized body takes into account the following aspects:

- priority of national labour resources, i.e. whether the need for employees can be met using national resources, including Russian employees from other Russian regions who have similar professions/qualifications and/or by retraining unemployed Russian nationals who have other professions/qualifications;
- outstanding breaches of Russian migration law in the previous and the current year by employers who are requesting a new quota;
- outstanding salary payments for a period exceeding three months, as well as outstand-

ing breaches of the Russian labour law that were discovered by the State Labour Inspectorate in the current year and in the previous years;

If the need for labour resources may be satisfied by using domestic resources, or an employer has committed any of the above violations, the authorized state body may refuse to grant the quota in part or in full. Notably, the above list of grounds for refusing a quota is exhaustive. State bodies responsible for granting quotas may not interpret it extensively. Therefore, if a responsible state body refuses to grant a quota to an employer for any reason other than listed above, such employer has a good chance of successfully challenging the refusal. In addition, an employer has the right to challenge any negative decision regarding the quota if they consider that such decision is incorrect. Alternatively, as mentioned above, an employer may also file an additional "corrective" quota application next year, so that the state body could reconsider the decision (i.e. grant a quota or increase/decrease the quota previously granted).

Moreover, when preparing a quota applica-

⁴ Job position titles in the quota applications should be named in accordance with the All-Russia Classifier of Professions and Job Positions approved by Resolution No. 367 of Russia's state standards body Gosstandart dated 26 December 1994

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KEY TRENDS IN RUSSIAN JUDICIAL PRACTICE RELATED TO PROTECTION OF THE INTERESTS OF FOREIGN INVESTOR COMPANIES

The Russian Federation, like other developed countries of the world, has a well organized judicial system which has proved to be rather effective and efficient, as is evidenced by the statistics on the number of individuals and economic entities seeking protection of their interests in the courts.

In our opinion, when conducting business, foreign investor companies should keep in mind that settlement of disputes and conflicts in court is common practice in Russia.

According to the statistics, this method of protection is actively used both by Russian companies and foreign investor companies, as well as representative offices operating in Russia.

Mostly, this can be explained by the effectiveness of the judicial system in comparison with other legal out-of-court methods. The judicial system can be particularly effective when settling disputes with the state authorities (for example, tax, customs, currency regulation authorities, etc.) The average percentage of decisions issued in favour of economic entities in disputes with state authorities is 70%.

Raisa has been providing legal services since 1994 and has extensive commercial litigation experience. Over the course of her career, Raisa has led many complicated projects and gained wide-ranging legal consulting experience with large-scale Russian and international companies on all types of corporate and commercial legal issues. She also chairs Deloitte's internal technical group, responsible for developing legal positions. In addition, Raisa has unique practical experience in resolving tax disputes, and serves as Head of the firm's Tax Dispute Resolution group. She has represented clients in more than 400 tax disputes, obtaining a favourable outcome in all but one case.

We believe that the main reason for the judicial system's effectiveness in Russia relates to its accessibility, as all Russian nationals and legal entities, as well as foreign entities and Russian non-nationals legally staying and conducting business activity in Russia, are entitled to apply to court in order to protect their rights and interests.

Moreover, all courts are made up exclusively of professional lawyers, which enhances the effectiveness and efficiency of the judicial system. For instance, settlement of disputes between economic entities and state authorities in commercial courts takes from nine to eleven months on average, including examination of the dispute in all judicial instances.

Alexei has specialized in court representation in tax and administrative disputes since 2002 and successfully represented Russian and international clients in arbitration courts and tax authorities. He also has significant tax consulting experience, including advising on various complex tax law issues and developing strategies for resolution of complex tax disputes. Alexei has significant skills in assessing tax risks on various business projects in Russia. He is a frequent speaker on tax dispute resolution topics for a variety of industries.

Another reason for the effectiveness of recourse to judicial authorities is the relatively low cost. Court fees payable for the admission of a case are not high. For instance, the fee for appealing against an act of state authorities amounts to 2000 roubles.

Enforcement of judicial decisions needs a special mention: in accordance with applicable law, judicial acts are obligatory for all state and municipal authorities, public associations and officials, individuals, and legal entities and are subject to strict observation throughout Russia. Failure to obey judicial acts can give rise to penalties, including criminal penalties.

Taken together, this explains why recourse to court is quite a popular method of interest protection in Russia.

The Russian judicial system consists of the

¹ Art.6 of the Federal Constitutional Law "On the judicial system of the Russian Federation" of 31 December 1996 No.1-FKZ

Constitutional Court of the Russian Federation, which examines the compliance of RF regulations with the RF Constitution, and federal courts of general jurisdiction, which deal with civil, family, hereditary disputes between Russian residents, and various kinds of disputes between individuals and legal entities including disputes with state authorities. Criminal proceedings are also subject to the jurisdiction of this category of court.

Commercial courts of the Russian Federation, which form the third separate system of courts, deal with disputes between legal entities, including representative offices and branches of foreign companies, and disputes between these entities and various state authorities (customs, tax, currency regulation authorities, etc.).

Arbitration courts should also be mentioned as they are actively involved in the settlement of disputes between economic entities. Arbitration courts are non-state courts, thus they are independent of any higher judicial authorities. Although the examination of disputes by arbitration courts is more expensive than by state courts, this type of judicial authority is rather popular among legal entities, including foreign investor companies. According to the general rule, the examination procedure can be initiated in the arbitration courts of the Russian Federation if the contract signed contains an arbitration clause. These courts do not deal with disputes arising from administrative and other public legal relationship (customs, currency, administrative relationship, etc.) (Resolution of the Constitutional Court of the Russian Federation of 26 May 2011 No.10-P).

As foreign investor companies can conduct activity in Russia only in two forms, as a representative office (branch) of a foreign company or as a founding member (shareholder, participant) of a Russian legal entity, possible disputes involving them can be

dealt with in the commercial courts only.

The Russian judicial system of commercial courts has four tiers: the courts of first instance, where cases are usually examined by a single judge, the courts of appeal (second instance) and courts of cassation (third instance). The Supreme Arbitration Court of the Russian Federation is a supervisory (fourth) instance that in practice rarely examines judicial cases.

Talking about judicial practice for foreign investors, we should mention the importance of the decisions made by the highest courts, including the Supreme Arbitration Court of the Russian Federation.

Below we will discuss what we believe are the most significant trends in commercial court practice related to the application of international law, including international treaties and participation of foreign investor companies, in commercial court proceedings in Russia.

One of the trends in the examination of cases involving foreign invested companies is an increased number of disputes requiring application of the law of other countries. Russian commercial courts have started more often to apply legislation of foreign countries when settling disputes between parties whose contractual relations are regulated by foreign law.



Although the examination of disputes by arbitration courts is more expensive than by state courts, this type of judicial authority is rather popular among legal entities, including foreign invested companies

Russian law does not, in theory, recognise judicial precedents, so that decisions made by the highest courts, including the Supreme Arbitration Court of the Russian Federation, are not treated as a source of law. However, in practice it does. Moreover, courts of first instance are guided by decisions of the Supreme Arbitration Court when dealing with analogous cases.

This should be taken into consideration as assessment of possible tax, legal and financial risks is closely connected with an analysis of trends in current commercial court practice. Government supervisory authorities (tax, customs authorities, etc.) generally also tend to stick to the positions taken by the Supreme Arbitration Court regarding certain issues.

Where Russian courts refuse to apply foreign law, this is usually associated with procedural breaches committed by the parties to the case, for example failure to give adequate and sufficient evidence regarding the substance of foreign laws, their official interpretation and their application in practice.

Taking into account this approach and the increased level of application or non-application of foreign laws by courts, we recommend that, when entering into contracts and including clauses on the application of non-Russian law, consultations be considered with experts who have requisite professional skills and are qualified to give an opinion on the interpretation and application of foreign law to a possible dispute.

Another significant trend to be noted is an increase in the number of cases where rulings issued by foreign courts in favour of foreign companies are acknowledged and enforced. Decisions of foreign courts are usually acknowledged and enforced by Russian commercial courts, taking into account international treaties and conventions signed by Russia.

It should be noted that a refusal to apply a rule of foreign law and acknowledge a foreign court decision is possible if such application or acknowledgment contradicts the public legal order of the Russian Federation, meaning that it impinges on the sovereignty and security of the state, affects the interests of large social groups, violates the constitutional rights and liberties of individuals.

In particular, the above situations may occur when a corporate dispute relates to the establishment of control over Russian companies of strategic importance (for example, defence industry, public transport, etc.) The types of activity of strategic importance for the RF are stipulated by a federal law (for example, mining, communication, nation-wide mass media, etc.).

However, recent court practice has been based on the assumption that the refusal to apply foreign laws or acknowledge a decision of a foreign court should be justified, and the fact of contradiction to the public legal order needs to be established and proven.

These days Russian courts often have to deal with arbitration clauses authorizing foreign state and arbitration courts to resolve disputes arising between parties to certain contracts. Such clauses are accepted by Russian courts and the dispute is submitted for consideration to an appropriate foreign court. The only exception is when the arbitration clause authorizes only one party to apply to a foreign court.

In such situations, as specified by the RF Supreme Arbitration Court, the other party also has the right to apply to a state judicial body (for example, a Russian one).

Another significant trend to be noted is the increase in the number of disputes associated with the application of international conventions and treaties ratified by the Russian Federation. This trend is particularly evident in the sphere of public law disputes between foreign investor companies and the RF (in particular, such areas as taxation, customs, etc.). Thus, Russian courts follow the principle of prevalence of international treaties over the Russian legislation.



Russian and foreign companies are treated equally by judicial bodies when considering their cases

At the same time, we would like to take this opportunity to note the trend towards literal interpretations by Russian courts of the provisions of respective international treaties. When general provisions of international treaties contradict specific norms of the Russian legislation, the priority is given to Russian legal norms.

For example, when considering a dispute concerning the application of general provisions of a Double Taxation Treaty related to non-discrimination against residents of treaty states, the RF Supreme Arbitration Court noted the priority of the specific rules of the Russian tax legislation regulating the accounting for taxpayers' expenses for income tax purposes over general provisions on non-discrimination. The RF

Supreme Arbitration Court also noted that the application of provisions of the Double Taxation Treaty with regard to the procedure for determining expenses of RF tax residents is beyond the scope of the treaty and contradicts the intended interpretation of the treaty as the treaty is intended to regulate only the procedure for determining the income of residents of treaty states. And the procedure for determining expenses is regulated by the rules of Russian tax legislation.

At the same time, Russian courts generally strictly follow the principles laid down by international treaties.

Unfortunately, it is almost impossible to cover all important judicial precedents that may be of interest to foreign investors in one article. The authors have aimed not only to illustrate what they think are the main trends of the commercial court practice, touching briefly on the structure and efficiency of the judicial system in the RF as a whole, but also to make readers understand that the idea of going to court to defend one's rights and interests is quite a popular and sometimes the only effective way of defence.

The significant experience of the authors in working with commercial courts and protecting the rights and interests of Russian and foreign companies shows that Russian and foreign companies are treated equally by judicial bodies when considering cases. Going into the essence of a problem is of utmost importance for dispute settlement. Equal treatment of Russian legal entities and foreign companies, as well as foreign investor companies explains the increase in the number of foreign investor companies going to commercial and arbitration courts in the RF, which is leading to a more rapid development of judicial practice involving such entities.

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STRATEGIC DEVELOPMENT IN ATTRACTING INVESTMENTS: RECENT INITIATIVES AND POLICY DOCUMENTS OF THE RUSSIAN FEDERATION AND THEIR IMPACT ON THE INFRASTRUCTURE SECTOR

With the ongoing crisis in the global economic and financial system, capital outflows from emerging markets and the slowdown in the Russian economy, Russia is beginning to actively participate in the global competition for investments. The task of large-scale and rapid development of infrastructure determines the need to attract a significant amount of investment in infrastructure projects. Corresponding problems have determined a shift in the understanding of public authorities of the importance and necessity of an attractive regime for investments, including foreign investments. The creation of appropriate legal, institutional and other conditions for investment activities has obviously become one of the main priorities of state policy for the near future.

Government policy in the field of investments, including in the infrastructure sector,

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is forming in stages: from policy statements of top officials to the creation of strategies for the development of certain industries and regions and the creation of legal and institutional mechanisms designed to attract investments to the infrastructure and other sectors of the Russian economy.

A number of statements have been made by top officials over the past few years, which have become the basis for future government policy regarding the creation and development of mechanisms to attract investments. Thus, the President proposed several important theses in his annual message to the Federal Assembly in 2010¹:

- in the first place it should be noted that the modernisation and creation of a "smart" economy requires new standards for the activities of public authorities and the provision of public services;
- it is necessary to develop a coherent pro-

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gram in each region to improve the investment climate and to create new, high-paid workplaces "on the basis of the so-called best regional practices. This includes reducing the period of time for issuance of permits required to start a business, creation of well-prepared industrial sites and a number of other measures";

- it is necessary to highlight the importance of creating additional incentives for regions (through the appropriate reallocation of federal subsidies), which achieve increases in their revenue bases.

In a message to the Federal Assembly in 2011 the challenge of decentralisation of government management in order to improve the implementation of the functions of the Russian constituent entities and municipalities, including ones in the economic sphere, was declared.

¹ Президент.рф/news/9637

Finally, in a message to the Federal Assembly in 2012 a strategic direction was formulated for the development of mechanisms of investment attractiveness:

- it is necessary to prepare a “road map” for the development of new industries, in parallel with the “road map” to improve the investment climate;
- it is pointed out that there is a need to create an “investment map of Russia”.

The above policy statements (along with other important statements made in the past three years), have formed the basis for subsequent work in the following areas.

Definition of development strategies of regions

Development strategies of certain industries and regions have been elaborated over the last few years, one of the main priorities of which is to provide for cooperation with the private sector and, therefore, attraction of private investments, including investments on a Public-Private Partnership (PPP) basis. Of particular importance is the role of PPP in the development of transport, municipal and industrial infrastructure.

Increase of the investment attractiveness and improvement of the investment climate in Russia

The challenge to create a favourable investment climate has become a major economic policy of the Russian Government.

The international ratings of investment attractiveness, where Russia is still far from being in the first place, have become a sphere of great interest for the state. In the World Bank's Doing Business 2013 Russia occupies the 112th place out of 185 countries (2011: 124th; 2012: 118th), and for the category “Protecting Investors” the 117th². The need to move higher in the rankings was observed not only in the speeches of top officials, it is also fixed in the legal framework of the Russian Federation. Thus, in accordance with Presidential Decree № 596 “On the State Long-Term Economic Policy”

dated 7 May 2012, the Government shall, among other things, improve the position of the Russian Federation in the World Bank's ratings on doing business to enter within the top 50 by 2015 and within the top 20 by 2018. It also aims to increase the volume of investment to not less than 25 percent of GDP by 2015 and up to 27 percent in 2018.

Vladimir Putin ordered the creation of a Standard for Executive authorities' activities, to ensure a favourable investment climate, following policy statements on improving the investment climate made during the tenth international investment forum “Sochi-2011”. Elaboration of a regional investment standard was assigned to a specifically established Agency for Strategic Initiatives³, one of the main aims of which is “to promote initiatives to improve the business climate”⁴. The aforementioned Standard was elaborated and submitted by the Agency in 2012, and establishes a set of organisational, legal, institutional and informational measures, aimed at increasing the investment attractiveness of regions, the protection of investors' rights and increase of entrepreneurs' support transparency. Among other things, the Standard provides for the following activities of regional authorities:

- elaboration of strategic documents of the regions in the field of investments: (a) the investment strategy of the regions, (b) the annual plan of investment and infrastructure projects, (c) the Investment Declaration of the regions;
- elaboration of the legal framework for investments' support in the regions: (a) the legal act on protection of the investors' rights and investment support mechanisms, (b) single rules for investment project tracking based on the principle of “one window”, (c) the legal act for the evaluation procedures

of the effect of voted legal acts that affect business relating to the project;

- elaboration of the institutional and organisational environment: (a) the presence of a Board for investment climate improvement, (b) the presence of a specialised body for investment attraction and investor relations, (c) the establishment of a specialised bilingual online portal on the investment activities in the regions etc.

The implementation of the Standard is currently being carried out in pilot mode in more than 10 regions of Russia. It is assumed that eventually the Standard will be implemented in all of the Russian regions.

It is also important to mention that the institution of a federal investment authorised representative was created in 2010 to accompany the projects of foreign and Russian investors. He is responsible for coordinating the activities of federal executive agencies to review Russian and foreign investors' submissions, as well as drafting of the relevant decisions of the Russian Government⁵. The institute of investment authorised representatives in the federal districts was created in 2011⁶. The experience of the first years of existence of these institutions has shown the feasibility and practical value of investment authorised representatives. More than a half of all submissions to federal and district authorised investment representatives have been successfully resolved.

Creation of legal mechanisms for financing infrastructure projects

As it has already been noted, the development of the infrastructure sector is a priority for the Russian Government. The necessary investments in roads, railways, airports, municipal and other types of in-

² www.doingbusiness.org/rankings

³ Established in accordance with the Russian Government Regulation No. 1393-r dated 11 August 2011.

⁴ Subparagraph (b) of paragraph 12 of the Charter.

⁵ Russian Government Regulation No. 1298-r dated 2 August 2010

⁶ Russian President Regulation No. 535-rp dated 3 August 2011.

infrastructure are estimated at one trillion roubles. It is obvious that the problem can not only be solved by governmental money. In this regard, there is a need to attract a significant amount of private investments in infrastructure projects.

One of the most promising mechanisms to attract investments in infrastructure projects is a Public-Private Partnership (PPP). Certain legal and institutional PPP instruments have been created over the last few years in Russia: the Federal Law "On Concession Agreements" was adopted in 2005⁷ (the "Law on Concession Agreements") and the Investment Fund of the Russian Federation was created to co-finance priority projects implemented on the principles of PPP, in addition to several development institutions.

A number of regulations aimed at creating new PPP tools and the legal environment for attraction of private finance for infrastruc-

ture projects are currently under elaboration in order to create additional conditions for the development of PPPs.

only one contractual model based on the ownership of the object of the agreement (BTO model) by the public partner. In addition, the Law on Concession Agreements

Infrastructure bonds

The Government of the Russian Federation considers the mechanism of infrastructure bonds as another promising mechanism



The government of the Russian Federation considers the mechanism of infrastructure bonds as another promising mechanism, with which to attract private financing for infrastructure projects

contains a number of articles that do not provide for the financial attractiveness of concession projects. The result of these limitations was a small number of concession agreements, which were signed and have been implemented. Thus market participants, as well as state authorities, came to the understanding of the feasibility of a

with which to attract private financing for infrastructure projects.

In accordance with the instructions of the President of the Russian Federation⁹ it was requested that the Russian Government develop and submit to the State Duma a draft federal law on investment through the use of infrastructure bonds in order to attract investments in long-term development projects in the transport, energy, housing and social infrastructure spheres, implemented in the format of PPP.

It is planned that the projects for all necessary legal acts will be finalised and submitted to the State Duma in 2013.

TIF

One of the instruments of PPP that enables financial attractiveness of infrastructure projects for investors to be secured is TIF which stands for "Tax Increment Financing", literally: "financing by tax increases". This is a mechanism of financing investment projects that includes attraction of private investments into infrastructure projects and their subsequent reimbursement to the investor due to an effective increase in tax revenues.



It is planned that the projects for all necessary legal acts will be finalised and submitted to the State Duma in 2013

separate federal PPP law elaboration which should regulate the various contractual PPP models.

The Ministry of Economic Development elaborated a draft law on PPP throughout 2012. This work was carried out with the participation of leading financing institutions and consulting companies. A draft federal law on PPP was submitted by the Government of the Russian Federation to the State Duma on 13 March 2013.

Federal law on Public-Private Partnership

The idea of elaboration of a separate federal PPP law has actively been discussed by market participants and experts over the past few years. The need for a new law is due to the fact that the current Law on Concession Agreements regulates

⁷ Federal Law No. 115-FZ "On concession agreements" dated 21 July 2005

⁸ Russian Government Regulations No. VZ-P13-9168 dated 23 December 2011 and No. ISH-P13-2467 dated 28 April 2012 Subparagraph (b) of paragraph 12 of the Charter.

⁹ Russian President Mandate No. Pr-930 (par. 9 a) dated 12 April 2012 and No. Pr-2083 (par. 2) dated 20 July 2011.

The essence of the TIF mechanism is that the investor builds an infrastructure facility on the condition of extra-budgetary sources of financing. The result of the construction of an appropriate infrastructure facility is an increase in budget revenues on the corresponding territory, due to receipt of additional tax revenues owing to increased business activity, trade, creation of new industries and housing. Reimbursement of investments to the investor and income support take place, respectively, during the phase of infrastructure operation by means of budgetary payments from the public partner, formed by these additional local budget revenues.

At present, the Ministry of Economic Development is working with the VEB on the elaboration of amendments to the legislation allowing the use of this mechanism for the financing of

investment infrastructure projects in the Russian Federation's constituent entities.

General Conclusions

Definition of the strategic role on the normative level of private investments and focused work aimed at the creation of a comfortable and effective mechanisms for the successful activities of Russian and foreign investors in Russia demonstrates the priority policy of the Russian Government to create all necessary conditions for attracting private investments to the Russian economy.

However, it takes much more than high-level declarations to create a favourable investment climate in the country. The investor community needs a clear statement of Government policy in the sphere of attracting private investments and implementing PPP. Preferably there must be a long-term

detailed programme covering a number of infrastructure sectors and industries. It may be complemented by recommendations to Russian constituent entities in respect of assessing and structuring PPP projects.

The task of the investment and expert communities at this stage is to promote and support competent public policy in the field of investments and PPP, to ensure "feedback" and to formulate further queries and suggestions to improve the regime of investment activity.



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CUSTOMS-RELATED ASPECTS OF THE IMPORT OF GOODS CONTAINING INTELLECTUAL PROPERTY: CRITERIA FOR INCLUSION OF THE LICENSE FEE IN THE CUSTOMS VALUE

A lot of questions are now being asked in connection with the import of goods containing intellectual property into the Customs Union (the CU). The most relevant ones concern the inclusion of license payments in the customs value of goods and confirmation of the correct determination of the customs value of goods containing intellectual property.

The Agreement of 25 January 2008 between the government of the Russian Federation, the government of the Republic of Belarus and the government of the Republic of Kazakhstan on the determination of the customs value of goods transported over the customs border of the Customs Union says that when determining the customs value of a deal in goods, to the price that was actually paid or is due for such goods one must add license payments or other similar payments which relate to the goods being so valued and which the buyer made or was obliged to make, directly or indirectly, as a condition of sale of such goods, to the amount not included in the price to be actually paid.

The first criterion deals with how the license fee as is calculated under the license agreement. This is supported by judicial practice. Let's take, for example, Ruling No. BAC-2316/13 of the Higher Arbitrazh Court of the Russian Federation dated 7 March 2013 in case No. A40-139377/10-148-926, in which the Higher Arbitrazh Court reaffirmed the judgement of the lower courts regarding the inclusion of the license fee in the customs value of goods: "The direct connection of royalties with the imported goods is confirmed by the fact that these payments were calculated on the basis of the sums received from the sale of these goods, which leads to the inclusion of the license fee in the customs value."

The linkage of the sale of goods to the payment of royalties may not be excluded entirely by virtue of contractual and other legal obligations. This is not always directly deductible from a contract or license agreement. In such cases, the decision should be made taking into account an analysis of all facts and circumstances associated with the sale and import of the goods. The factors that one needs to pay attention to include the following:

- whether the license fee is mentioned in the sale & purchase agreement and documents pertaining to it;
- whether the license agreement contains a reference to the sale & purchase agreement;
- whether the sale & purchase agreement or license agreement provides for the ability to terminate it in the event of the buyer's non-payment of the license fee to the licensor, which would confirm the linkage of the license fee payment to the sale of the goods being valued;
- whether the license agreement contains a provision that prohibits the manufacturer from producing and selling the imported goods which were made with the use of licensor's intellectual property in the event of non-payment of the relevant fee to the licensor;



Wilhelmina Shavshina

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Wilhelmina provides integrated support for international investment projects and cross-border transactions, and advises on customs value, customs administration and the use of simplified customs clearance procedures. She oversees the process of customs duty reduction, assists in solving customs disputes and advises on other aspects of customs regulation.

- whether the license agreement contains a provision that allows the licensor to control the manufacture of goods and the sale of goods by the manufacturer to the importer (export sales to the importer's country) not within the framework of quality control.

The next criterion is whether the license fee relates to the goods being valued (imported). Clause 11 of Commentary No. 3 of the EC Customs Valuation Compendium (international rules and documents which were devised by the World Customs Organization (WCO) and compiled in the so-called compendium; members of the WCO are obliged to apply them, since they are aimed at ensuring consistency in the application of customs valuation rules) sets forth: "In determining whether a royalty relates to the goods to be valued, the key issue is not how

the royalty is calculated but why it is paid i.e. what in fact the licensee receives in return for the payment.”

Accordingly, one can conclude that if proceeds from the sale of imported goods are not taken into account when one calculates the sums of the licensee fee (for example, when the license fee is calculated only on the basis of the sales of products made in Russia, which products can be distinguished from others by way of indicating stock numbers and information on the suppliers of such products), such license fees do not relate to the goods being imported and, hence, should not be included in the customs value thereof. Thus, when drafting a contract for the use of intellectual property, it would be reasonable to determine and pay attention to—and further confirm by documents to a customs body—not only the calculation of the license fee, but also what it is paid for.

For example, it is necessary to divide the sums of the license fee into those which are paid for the transfer of particular rights in relation to the goods being imported and those which are paid for the transfer of rights to the manufacture of such goods. Otherwise, a customs body may calculate the customs value and the license fee taking into account the value of rights relating not only to the goods being imported, but also to the ones made in the CU.

If an organisation has a license agreement or another contract that provides for the transmission of payments for the use of intellectual property, it is in the interests of the licensee to have documents that can be provided to a customs body by way of confirmation of data that was stated in relation to the structure of the customs value of goods: data regarding the terms of the license agreement, accounting letters outlining the calculation of license payments and the like.

If the license fee is included in the price of the product, for example in the course of the delivery price formation, this needs to be mentioned in the license agreement and in the delivery contract, and the customs body should be provided, where possible, with documents confirming the calculation of the price (ideally a letter from the supplier regarding the product price structure) when one declares the product.

The law enforcement practice of the customs bodies is also based on a letter of the Federal Customs Service of Russia No. 05-33/39045 dated 22 September 2008, which says that if it appears impossible to work out universal methods of the license payment calculation, such a calculation must be done in relation to the particular circumstances and terms of the license agreement depending on the documents the declarant has. Accordingly, it is in the interests of the declarant to make the calculation of license payments simple and clear, and to prepare a set of documents which include its own license payment calculation method based on the particular circumstances of the deal, while having included in the license payment the charges that are due under customs legislation.

When checking information about the customs value which was stated by the declarant in the course of declaring the goods, especially that portion of such information which concerns the inclusion in the customs value of the license fee for the use of software, know-how and/or a commercial name, the customs bodies ask whether royalty for the use of software, know-how and a commercial name “relates” to the goods being imported. In determining whether a royalty relates to the goods to be valued, the key issue, in the opinion of the customs bodies, is not how the royalty is calculated, but why it is paid, i.e. what in fact the licensee receives in return for the payment. The establishment of the fact that expenses incurred in paying royalties are charged to the prime

cost of the goods or to other expenses will allow one to trace the connection between these payments and the imported goods.

However, judging by the post-release control practices pursued by the customs bodies, it appears that they consider a field customs audit, which is conducted on the premises of the auditee, as the most efficient form of customs control. In the course of such an audit, the customs body will analyse the accounting documents, checking, inter alia, how the license fee is booked for accounting purposes. When doing so, the customs body will verify data on the accounting records of the auditee, for example, account 15 “Procurement and acquisition of material assets”, account 41 “Goods” and account 44 “Sales expenses”.

In the opinion of the customs bodies, it is not efficient to conduct additional audits of documents or in-house audits, since they do not exclude the possibility of the provision of false data by the auditee or the taking of an incorrect decision by the customs body owing to the provision of limited information.

International practice has shown that it is impossible to further re-qualify a license fee into a different payment. It is expressly set out in EC legislation that if a payment is, by its nature, a licensee fee for the use of intellectual property, it cannot be re-qualified into subsequent income: “Payments which fall within the definition of license fees for the use of intellectual property may not be re-qualified into part of profit or revenues from the subsequent sale, other disposal or use of the goods by the buyer”. (Commentary No. 3 of the EU Compendium, clause 20)

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INVESTMENT RISK ASSESSMENT: IP DUE DILIGENCE

Today such intangible assets as Intellectual Property (trademarks, trade secrets, inventions, utility models, industrial designs etc.) are of great interest to investors and businesses. As potentially valuable assets, IP can be a substantial portion of an investment and, therefore, require professional Due Diligence (DD) before any transaction is completed.

The essence and the goals of IP Due Diligence

IP DD is first of all a pre-investment audit, which should give reliable and accurate information concerning the IP objects of interest for the investor. It should examine title to these objects and reveal existing risks related to usage of them. Any risks revealed can affect the decision of the investor on the transaction.

Performing IP DD is becoming general practice, especially in innovative businesses where IP can be a valuable asset. It is the legal and technical review within an IP DD which reveals the circumstances preventing the transaction or affecting its price and terms. Revealing such circumstances can avoid costly mistakes, decrease the likelihood of adverse effects with respect to existing risks and determine correctly the cost and structure of the intended transaction. It can even lead to the investor's abandoning a transaction.

Performing IP DD is a voluntary act, however. But practice shows that lack of attention to the review of intangible assets can put at risk the success of an investment project as

a whole. The main problems which investors face in Russia include a lack of properly formalized documents to prove that the apparent holder of the title actually possesses the right to dispose of it.

Tasks completed within the framework of IP Due Diligence

IP DD is aimed at the comprehensive examination of IP involved in a transaction, specifically:

- determining the IP objects which are the subject of the transaction;
- checking whether the holder of the title possesses of the rights to the corresponding results of intellectual activity, and examining the term of validity of such rights;
- examining the essence of IP objects and the scope of IP rights in order to ensure that they correspond to the investor's interests and are properly protected;
- revealing any possible hindrances for disposing of the exclusive rights;
- revealing any third-party rights that could affect IP commercialisation;
- checking compliance with the requirements settled by law in respect of granting legal protection to the results of intellectual activity.

Even preliminary evaluation in respect of this list of IP DD issues can assist the investor in revealing IP-related problems and, therefore, in reducing considerably the risk of acquiring useless assets.

IP Due Diligence: essential issues

In IP DD the formal issues are checked, specifically whether the rights to IP objects of interest for the investor are acquired and duly formalized. Thus, IP objects can be the results of intellectual activity, created in the course of employment or created under independent-work contracts, agreements for research and development, or engineering and technological work. The IP rights can be purchased from third-parties or used under a licence.

**Alla Derzhavina**

Alla graduated from the Russian Foreign Trade Academy and successfully completed training courses in the Russian State Intellectual Property Academy and WIPO Academy.

She has wide experience in handling IP-related projects for a number of key Russian and foreign companies.

As a Partner and Head of Practice, Alla is widely involved in representing the clients in IP-related disputes in courts, the Chamber of Patent Disputes of Rospatent and antimonopoly bodies. She is also constantly contributing to the development of IP legal science in Russia by writing publications, reviews and commentaries on the most crucial issues and complicated matters of practical implementation of the law.

It is also important to define the scope of protection of the results of intellectual activity and the potential encumbrances imposed on them (e.g. pledge of exclusive right), to check for any third-party claims related to usage of IP or any IP-related litigation.

A legal review of the agreements ruling the issues related to creation and usage of IP rights constitutes an important part of IP DD. These can include the following:

- agreements on the alienation of exclusive rights to the results of intellectual activity;
- licence agreements (it is important to focus on the licence type (exclusive or non-exclusive), term of validity and effective territory of the licence);
- employment agreements;

- agreements with independent contractors, R&D agreements (it is crucial to focus on the provisions settling the allocation of the rights to the results of intellectual activity as well as on the terms of granting to the contractor the right to use the results of intellectual activity);
- franchising agreements;
- addendums and supplements settling the procedure of disposal of IP rights.

In addition to a legal review of the provisions of the agreements, compliance of the agreements with the formal requirements of the law is examined in IP DD. For example, according to the Russian legislation agreements on the alienation of exclusive rights (to the inventions, utility models, industrial designs, trademarks, registered software, databases and topologies of integrated circuits), licence agreements (granting the rights to use the inventions, utility models, industrial designs, trademarks and topologies of integrated circuits) as well as franchising agreements for use of IP objects are subject to compulsory state registration with the Federal Service for Intellectual Property, Rospatent. Without such registration these agreements are invalid.

Moreover, any agreements to change the essential terms and conditions of an agree-

can be subdivided into four main groups: patent rights, rights to trademarks, copy-rights and rights for trade secrets (know-how).

The main issues it is necessary to focus on in respect of each IP object include the meaning for the investor, ownership of exclusive rights, restrictions of use (territorial limitations, time constraints, restrictions on assigning the rights), and encumbrances (licenses, pledge etc.).

Patent rights

The patent rights are the IP rights to inventions, utility models and industrial designs. Occurrence of patent rights is subject to and conditional upon state registration, such patent rights being confirmed by a patent effective within a territory for which protection has been claimed. Exclusive rights to an invention, utility model or industrial design is recognized and protected within Russia provided that they are registered with Rospatent.

The investor needs to assure himself that the technologies are duly protected and used.

IP DD checks the following patent-related issues:



As potentially valuable assets, IP can form an essential portion of the transaction cost and, therefore, require for professional Due Diligence of such transaction

ment registered, or to terminate such agreement, pledge of exclusive right, sub-license agreements and sub-franchising agreements, are subject to state registration with Rospatent, as well.

IP evaluation

IP rights examined and evaluated in IP DD

- the degree of protection of technologies and other patented objects by means of patent protection;
- conformity of the rights provided by the formula of the invention (utility model) or by the set of industrial design essential features to the transaction purpose;
- the legal status of title documents and

patent fees and duties to be paid;

- the remaining unexpired term of validity of patent rights and in this respect the reasonability of these IP objects for the investor (validity of patent rights: 20 years for inventions, 10 years for utility models with the option to prolong for 3 years, and 15 years for industrial designs with the option to prolong for 10 years);
- the entire chain of assignment of patent rights;



The investor needs to assure himself that the technologies are duly protected and used

- observance of the author's rights in course of obtaining a patent (the patent can be invalidated if it was obtained in violation of the requirements of law to specify in the patent the real authors of the result of intellectual activity, by whose creative labour such a result was created, as well as to indicate, as the patent-holder, the party entitled to obtain the patent);
- compliance of the result of intellectual activity with the patentability requirements set by the law, and
- patent clearance of the technologies.

Right to a trade secret (know-how)

According to the laws of Russia, exclusive rights to a trade secret (know-how) can occur only after giving commercial confidentiality status to this know-how. They shall remain in effect while the confidentiality of the information constituting this know-how is retained.

IP DD in respect of trade secrets is aimed at ensuring that the proper steps have been taken to provide legal protection of these trade secrets and reveal potential leaks of information about the essence of know-how.

Such IP DD will involve examination of legal, technical and administrative measures in respect of the confidentiality of the information constituting the trade secrets, checking all the appropriate agreements governing the use of such information and all know-how-related agreements (employment agreements, civil contracts, license agreements).

while the holder of such exclusive right is entitled to demand invalidation of legal protection of the competitive trademark).

Copyright and proprietary rights

IP DD of copyright and proprietary rights can also be reasonable, in particular in respect of design works, software or the documents protectable as copyright.

the investment object, to assure himself whether accepting these risks is reasonable and, therefore, to make informed decisions about the proposed transaction. Moreover, a skilled lawyer carrying out an IP DD can make suggestions for eliminating or reducing the IP-related risks, where possible, and handle the transaction to reach the client's final objectives.



IP Due Diligence is a crucial step in terms of preparatory stage in respect of transaction involving IP, which enables the investor to obtain reliable information reflecting potential risks related to the investment object

Since the exclusive right to the trade secrets of all holders ceases as soon as the confidential information constituting the trade secret is disclosed, it is necessary to ensure that all parties using the know-how should take proper measures to protect it.

Rights to trademarks

Trademark obtains legal protection in Russia after registration with Rospatent.

Within the framework of IP DD the following matters can be examined, including:

- title and encumbrances;
- legal status of registration;
- usage of a trademark (if a trademark is not used for three years, it can be deprived of legal protection upon request of any party concerned, so it is necessary to assure that such risks are not likely to occur);
- existence of competing means of identifications, such as brand names and commercial designations (if the exclusive right for the means of identification occurred earlier, this means of identification will prevail,

Problems which can be revealed further to IP Due Diligence (examples):

- lack of documents to prove title to the results of intellectual activity.
- lack of duly performed agreements for using IP objects.
- non-existence of commercial confidentiality status in respect of technologies which have not been patented.
- failure to pay remunerations to the authors.
- existence of competing means of identification which have occurred earlier.
- failure to use the results of intellectual activity.
- absence of provisions settling the rules of assigning the rights to the results of intellectual activity in the agreements with contractors or incorrect drafting of such agreements.

IP DD is a crucial step in the preparatory stage of transactions involving IP. It enables the investor to obtain reliable information reflecting potential risks relating to

The adverse effects investors can face in the absence of IP DD in most cases can be worse than the possible expenses and time involved in performing IP DD.

Due to the variety of transactions, the character and the scope of IP DD for each one will have its peculiarities. Meanwhile, it is reasonable to trace the whole chain of occurrence and assignment of the rights to IP objects involved in a transaction, as well as to check the protectability and exclusiveness of the results of intellectual activity.

Michael Akim

Director of Strategic Development, ABB Russia

THE RUSSIAN ECONOMY: INVESTMENT IN MODERNISATION AND INNOVATION

The Russian Minister of Economic Development, Andrei Belousov, has said, "Russia's labour productivity is lagging behind developed countries by 2.5-3 times and is at the level of Chile and Mexico."

Developing productive and internationally competitive sectors, particularly in manufacturing, is one of the most serious challenges facing the Russian economy and government. Russia's manufacturing value added per worker is about the same as China's and India's, but due to its higher labour costs, Russia's labour productivity ranks behind that of most of central Europe, and all the advanced industrialized countries. This reflects a shortage of skilled labour, despite high enrolment at higher education institutions. Labour costs are growing in Russia. They are already higher than in the CIS and some neighbouring former Soviet bloc countries, and are particularly high in Moscow. It might be not a critical issue right now due to market attractiveness, but it could be a limiting factor soon. Russia will not be able to compete with developing countries that have cheaper labour forces without taking significant steps to adopt new technologies for productivity improvement. According to "The Russia Competitiveness Report 2011", published by the World Economic Forum: "Competitiveness enhancing reforms will improve the business environment, strengthen efficiency, and align manufacturing productivity better with international wage-productivity ratios."

Globalisation, and particularly Russia's accession to the WTO, has dramatically increased the importance of productivity as a source of sustainable prosperity for the country. Therefore adapting to new technology, skills acquisition, and the absorption of knowledge have become critical sources of economic growth and wealth.

Impact of WTO on major segments

The last decade showed sustained economic growth and political stability, which is essential for business planning, but the competitiveness of Russian enterprises is increasingly threatened by the strong rouble, climbing resource prices, and rising wages, as well as the take-up of Russia's excess industrial capacity. WTO membership will help lower Russian tariffs, and the laws governing import-export procedures will be liberalized to boost business's ability gradually to increase its spending power, and widen choice as certain previously protected industries are opened up to foreign competition. Investcafe's analyst, Ilya Rachenkov, says, "Joining the WTO [leaves] Russia [with] no effective instruments for protecting domestic producers." He adds, "General reductions in import tariffs will be beneficial for foreign producers as this will make their products more competitive."

The potential for oil and gas sector growth is limited due to the continuing depletion of existing fields and the consequent move to more expensive drilling projects in remote, undeveloped regions and off-shore. WTO regulations could support the technology transfer that is essential for off-shore, and particularly polar off-shore, development.

The WTO should have a positive influence on export-oriented metal and coal producers. Increases in local consumption by the metals industry will also create additional demand in the mining industries. The mining and minerals industries also require support for the implementation of new technologies if they are to compete with other extraction-based economies, such as Australia or Brazil,



Michael Akim

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which have already developed their production capacity.

Russian geography, with its huge distances for deliveries goods, materials and energy, is unique and requires special development to address country-specific conditions. For instance, power needs in remote locations will require a new approach to generation that might include renewable power sources and the development of micro-grid technologies. This could lead to investment in infrastructure technology development.

Competitiveness of Russian industry

There are some key factors that define the international competitiveness of Russian industry: a domestic focus, with few producers

trying to sell outside the CIS, and a limited knowledge of foreign markets and technologies, particularly caused by the language barrier and high cost of credits. The Minister of Economic Development, Andrei Belousov, has stated: "interest rates... for loans with a term of more than one year are over 12%."



The implementation of the best project practices is essential for capital project cost and risk reduction

As noted by the Economist magazine, many multinational corporations can borrow money cheaper than European governments, and, therefore, incomparably cheaper than Russian ones. While small and medium-sized companies are usually the most flexible and entrepreneurial globally, it is often difficult for them to access cheap money to be able to exploit Russian opportunities and to cover the high cost of entering the Russian market. The low rates enjoyed by major multinational firms should stimulate acquisitions, and encourage companies to build new factories and employ new workers. However, businesses consider projects based on their expected returns. Russian capital projects are significantly more expensive than comparable ones. A spokesman for Strategy Partners says, "In general, the major factor is ineffective business processes and organization." Implementation of the best global project solutions is needed in order to reduce project costs. The factors to be considered for any investment project include the balance of supply and demand in the industry and region, geographic proximity, infrastructure, the regulatory and political situation, and the availability of a skilled workforce.

Current cost structures do not support the global competitiveness of Russian manufac-

turing. One of the real disadvantages of the current system is the unreasonably inflated prices that Russian industry and consumers have to pay for goods and services, and particularly for imported goods, compared to other global markets. This is partly due to ineffective transport infrastructure, the cost of inbound and outbound transportation caused by tariffs and distances, the situation with the customs service, the number of intermediaries with high margin expectations, and the generally obscure regulatory environment. Combined, these have a significant negative impact on the cost of industrial investment and modernization projects, and the competitiveness of Russian manufacturing operations.

The implementation of the best project practice, such as the MEC (Main Electrical Contractor) and MAC (Main Automation Contractor) approaches, is essential to reduce both capital project cost and risk. It is vital also to ensure reliable interface management and define responsibility throughout the full project lifecycle, from Front End Engineering and Design (FEED) to completions, start-up and service.

The implementation of automation technologies using modern robots is crucial to boosting the competitiveness of Russian producers by reducing operating costs, improving product quality and consistency, and enhancing the work environment for employees. This should result in increased output rates and manufacturing flexibility, reduced material waste, and increased yield. Zero duties for some high-tech goods within three years after joining the WTO should support such developments. This encourages the trend towards foreign equipment and products, and best practice, that are crucial for resource productivity.

Several joint programs have been carried out with foreign companies. As a result of this cooperation, local enterprises get investment and new technologies which should

mitigate the effect of joining the WTO.

Integration of the best global practice and technologies for modernization

Very few big Russian plants have been constructed in the last 20 years, so technology in the manufacturing sector is largely obsolete. The manufacturing-for-export model is unlikely to work in Russia because of relatively high labour and other costs. The task of changing the economy over to innovation-based development methods as defined by the government was positively received by the business community. However, a lack of understanding of the practical meaning of the term "innovation" leads to misuse, and claims that unusable and non-competitive products, processes and business models are actually innovations. The resulting irregularities worsen the investment attractiveness of Russian industry.

The support of the Russian government is essential for foreign investors in research, development, implementation and the commercialization of innovative products in Russia which needs to use the process expertise of world leaders, and collaborate in R&D. The state has introduced stimulus packages for innovation development (such as decree No. 218, etc.), with the purpose of facilitation of involvement of foreign companies with innovation development programs in Russia.

However foreign participation is limited due to paperwork requirements. There are opportunities to improve information exchange between foreign companies and Russian development institutes, ministries and agencies concerning innovation development programs in order to make use of the experience of the world-leading companies which are represented in Russia. More international cooperation is needed to develop a common knowledge-based evaluation system to benchmark Russian innovation and engineering practices, and to define the most competitive ones against best global experience, and BATs.

Essential steps would be to reduce costs and to focus on developing competitive enterprises and industries, and to redirect those which cannot be competitive within the structure of the existing distribution of labour and sources. Major steps to boost competitiveness should be the adoption of the major global trends in technologies. This would involve acceptance of, and support for, sustainable manufacturing, an increased role for information technology, modelling and simulation in the manufacturing process, acceleration of innovation in supply-chain management, and implementation of rapidly interchangeable manufacturing systems in response to market needs. Resource-efficient investments and demand management should become the main feature of technological progress, to help avoid wasted infrastructure investment so that funding can be targeted where it is most needed. Investments in resource productivity, such as energy efficiency, have a higher economic multiplier than general expenditure, as resource-efficient investments provide a substantial financial return as well as usually providing productivity improvements.

Sustainable Development and Energy Efficiency

The establishment, promotion and adaptation of sustainable design standards has become extremely important within the context of Russia's WTO accession. There is a desperate need for a Russia-wide improvement of resource-use efficiency, as well as a general focus on sustainable development principles, such as water footprint, carbon footprint, global warming potential, climate change, ozone depletion, soil and water oxidation, metropolitan atmospheric pollution and equipment emissions if Russia is to be competitive in a global environment.

A comprehensive, modern approach to energy and environmental services should provide access to best global experience for benchmarking. Industrial companies and power utilities are among the largest users of energy and are therefore among the most

sensitive to the need to be more efficient. A systematic approach to energy efficiency for industrial plants requires identification of the potential for savings in energy use in both the plant utilities systems and the core production process. Therefore it demands a deep understanding and knowledge of industrial processes and technologies to challenge consumption patterns at the point of use, and reduce wastage by eliminating losses and improving the efficiency of generation.

There is a set of common solutions and tools for savings that are relevant and useful for most industrial plants, and particularly beneficial for Russian manufacturing due to age of most manufacturing assets. Electrical energy can be saved by optimising load scheduling, having variable speed drives and more efficient electric motors. Other measures include reducing harmonics and improving the power factor, optimising burning by reducing the fuel demand and fuel mix while implementing alternative fuels, the recovery of waste heat, air, steam, heat distribution control, loss prevention monitoring, technology analyses and process optimisation, which could be the most important one.

Recently we performed some Technical Policy and energy efficiency study projects for major Russian customers to benchmark their technologies and manufacturing processes against best available global practices. Energy improvement optimisation studies follow globally proven procedures, that enable mapping the production, distribution and use of energy and utilities across the site and analyse this information to identify opportunities for improvement, and the likely value range of each opportunity. This approach requires a broad knowledge base and a comprehensive analysis of the acquired process data using tools and techniques developed by global team of Energy Consultants, Process Engineers and Technical Specialists with a wide variety of technical and business expertise. It includes a variety of energy efficiency solutions for various industries, for example cost, efficiency, production rate and

recovery factor improvement for pipeline solutions of O&G systems, open-pit and underground mining, for transport and many other industrial applications.

Conclusion

Additional incentives to absorb advanced global technologies and measures are critical for economy-wide value creation from improved firm-level productivity due to increased competition, trade flows, worker mobility and training, and foreign direct investment in modernization. Russia has launched 32 priority technological programs covering the highest priorities of technological development: smart grids and a new power sector, composite materials, medical technology and biotechnology, agricultural technology, aviation technology, space technology, and nuclear technology. A common roadmap is crucial for the realization of the EU-Russia Program "Partnership for Modernization", which provides a link between Russian and EC technological platforms to prevent duplication effort. The country has initiated programs for the establishment of venture capital funds, the formation of industrial technology parks, better protection and enforcement of intellectual property rights, and has started to focus on improvement of its national research and development institutions and industry in order to open the door to global players.

Major multinational corporations have the cash that could be invested in Russian modernization. Russia is making a commitment to address the weaknesses in its investment climate that have limited the country's productivity, modernization and innovative potential in the past. A direct dialogue of equals between the Russian authorities and foreign investors to define mutually attractive areas for modernization and innovation, establish stable and mutually acceptable conditions to support technology transfer, stimulus packages for joint development and implementation for innovations would pave the way to attracting the "smart money" needed for the modernization of the Russian economy.

Sven Lexner

Senior Partner, Mannheimer Swartling

THE ON-AND-OFF ALLURE OF JOINT VENTURES IN RUSSIA

“Joint ventures in Russia” is a charged combination of words. Lawyers will point to the complexities in creating a legally solid joint venture (JV) under Russian law; management consultants will point to the high failure-rate of partner set-ups; and foreign investors who have been burnt by their experiences in Russia will tell others never to go down the joint venture route. Still, for several years the term “joint venture” was synonymous with investing and doing business in the new Russia, and quite understandably so, as investing in a joint venture was the only way for a foreign party to make a lawful investment in the market. In certain sectors of the Russian economy this is still the case. This is not to say that joint ventures today are chosen merely for the sake of legal necessity. There are today thousands of joint ventures in Russia, and most of them have been created after a careful review of other options. Any foreign investor going to Russia will in one way or another have to relate to joint ventures.

Periods of popularity

The popularity of the joint venture as a vehicle for investing in Russia has waxed and waned over the years. The first wave followed after the adoption in 1987 of two government decrees which introduced the very term “joint venture”. They defined a joint venture as a special form of legal entity, in essence a company, and holder of equity investments by a foreign and Russian investor. Joint ventures had their own charter capital, management structure and internal rules in the form of a charter. Initially, the participation of foreign joint venture partners was

limited to 49 percent of the equity in the company and foreign citizens were not allowed to hold the position of chairman or general director. Nonetheless, the company form was a novelty and presented the only lawful option for equity investments in Russia, hence attracting much interest from foreign investors.

The novelty of the original joint venture started to wear off quite quickly, especially after a new presidential decree in 1990 allowed for foreign investors to set up wholly-owned companies in Russia. The original joint ventures from the 1980s started to gradually disappear, until they were abolished altogether in 1995.

A second wave of joint ventures followed in the wake of the financial crisis in 1998. While many Russian owners of companies found themselves stranded with small financial means, they controlled other assets in their companies, such as licenses for certain types of activity or industrial premises attractive enough for foreign investors to dare to invest directly in such companies.

The past few years have again witnessed a rise of joint ventures in certain industries deemed to be of strategic importance to the Russian economy. Russian law now requires that foreign investors seek permission from a special governmental committee if the size of its stake exceeds a certain proportion. But the field is generally left open for joint ventures with foreign minority holdings.

An important development has been the possibility to use an offshore structure for joint projects in Russia. Offshore joint ventures made their appearance around 2004 when the new law on currency control came into force and especially later, in 2006, when certain important limitations under the currency control law were removed, allowing for Russian individuals and companies to own shares in foreign companies. This opened up the possibility of creating

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joint ventures abroad but with a wholly-owned subsidiary in Russia.

What is a joint venture and what is it not?

While the original joint ventures constituted a particular legal form, which rightfully could be called “joint venture company”, there is currently no definition under Russian law of a “joint venture”. Generally, if the term is used in Russia in its English language form it will be understood by Russians and foreigners alike as a company with two or more Russian and foreign shareholders, who are pursuing a common purpose or project in Russia through that company. (Other forms of joint ventures exist, even those without an equity investment, but the normal understanding of the term would be as just stated.) A joint venture today is not a special legal form and no company can be registered as a “joint venture company”. If the joint venture is set up in Russia, the choice of “legal platform” would normally be either a closed joint stock company (ZAO) or a limited liability company (OOO).

Whatever form is chosen for the set-up, the partners' common purpose with the joint venture will be—or should at least be—expressed in a shareholders' agreement. The shareholders' agreement is the legal key to the parties' aims and should also be a determining factor in where to incorporate the joint venture, and what company form to choose for it if set up in Russia.

Where to set up the joint venture: the role of the shareholders' agreement

The shareholders' agreement is the legal key to the success of a joint venture. It is the formal embodiment of the parties' joint un-

rules on shareholders' rights in other Russian laws. The effect is that the status of many of the provisions that are standard in modern agreements is uncertain under Russian law. For example, provisions relating to the following will not be enforceable in Russia or it is at least unclear whether they will: options, waivers, non-compete clauses, ordinary voting arrangements, indemnity provisions and most of the exit provisions that are common in shareholders' agreements in the West.

So what to do? Well, the first advice to the foreign investor, in a situation where the joint venture for one or another reason

viding for arbitration outside Russia, such as for example the Arbitration Institute of the Stockholm Chamber of Commerce or in a similar organization. This will not cure the shortcomings of the regulation of shareholders' agreements under Russian law—and Russian law is mandatory for a joint venture incorporated in Russia—but at least it will move any disputes out of Russia onto neutral turf. An award from such an institute is normally, if with some difficulty, enforceable in Russia.

However, the paradoxical advice to a foreign investor intent on setting up a joint venture in Russia is... not to set up the joint venture in Russia, but elsewhere, and then have the joint venture set up a Russian operating subsidiary which will carry out the common project. If the partners are able to set up the joint venture company offshore, and depending on the jurisdiction they choose, it is possible to choose a governing law for the joint venture that will give both sides the possibility to negotiate terms for their cooperation which will give them the necessary flexibility to operate their Russian subsidiary, safeguard their rights but also hold them to their commitments if a dispute should arise.

Factors for success or failure of a joint venture

In contrast to other ways of entering the Russian market and, in a best-case scenario,



The shareholders' agreement is the legal key to the success of a joint venture

dertaking; it spells out their rights and obligations; defines the purpose for which they have created the JV; sets forth their agreed contributions; describes how they have come to enter into the JV; regulates how they will exit it; stipulates how the JV shall operate; and contains the agreed business plan with the objectives and targets of the JV. The problem with shareholders' agreement is just one: they do not really work in Russia when they really need to. For all practical purposes, shareholders' agreements for a Russian JV are not enforceable in Russia.

Although shareholders' agreements have been used by foreign investors and their Russian partners for more than two decades, they have only been explicitly acknowledged in Russian company law since 2009. Despite this acknowledgement there is no comprehensive regulation of shareholders' agreement in Russian company law. Instead, the wording is very short. With respect to shareholders' agreements in limited liability companies, it consists of only a short subparagraph. Without a more systematic treatment there is a clear risk of conflicts with

needs to be incorporated in Russia, is to try get a controlling share. Russian law may have failed in giving shareholders certainty in contracts, but at least it awards substantial rights to majority shareholders in Russian companies. The second advice, though not necessarily less important than the first one, is to choose the proper Russian company form for the joint venture. In the choice between a closed joint stock company (ZAO) and a limited liability company (OOO), the joint stock company, although rather te-



In a business culture so driven by personal relations as the Russian, presence and keeping one's commitments to one's partner is key

dious and clumsy to operate, is usually to be preferred as the relevant law provides for more sophisticated regulation and better protection of shareholders' rights. The third piece of advice is to insert an arbitration clause in the shareholders' agreement pro-

a joint venture with a Russian partner will allow the foreign investor to: kick-start a business on the Russian market; capitalize on the Russian partner's access to local networks; walk into up-and-running offices or facilities for production, manufacturing and

retail; take advantage of the partner's experience in managing a local workforce; and be spared much of the trouble in dealing with local bureaucracy and petty officialdom. In some cases, depending on the goal, it may allow the investor to gain access to Russia's rich sources of raw materials and comparatively inexpensive technology.

On the other hand it is true that the failure rate of joint ventures in Russia is high. The number of joint ventures quoted to be failures are in the range of between 50 and 70 percent. The reasons most often pointed to are: diverging interests between the foreign and the Russian partner; a lack of clearly defined objectives for the joint venture; differences in the understanding of the partner's respective contribution to the common effort; and a general lack of understanding of

each other's corporate cultures and how the business should be run. Conversely, a successful joint venture requires a high degree

there is one single reason why joint ventures in Russia fail, it is the belief on the part of the foreign joint venture partner that, once set-



Joint ventures had their own charter capital, management structure and internal rules in the form of a charter

of trust and commitment by the parties, as well as a common understanding of which way the joint venture shall be managed and how it shall act in relation to its staff, distributors and customers and the Russian authorities. From our own experience we would point to the importance of the physical presence in Russia of shareholders. If

up, the joint venture will run more or less by itself on the basis of the parties' agreement. The biggest mistake a foreign investor can make in a joint venture is to try to run it by remote control. In a business culture so driven by personal relations as the Russian, presence and keeping one's commitments to one's partner is key.

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DECIDING ON A JOINT VENTURE WITH A RUSSIAN PARTNER: ONSHORE OR OFFSHORE?

Do you really need a joint venture?

A joint venture (JV) is one of the most attractive and, at the same time, more difficult forms of investment. But before considering different JV structures, an important initial question needs to be answered: does it really make sense to enter into a joint venture, or can the project be performed without a partner, e.g. through a subsidiary or by acquisition of a Russian company? In other words, what are the advantages and disadvantages of a joint venture?

The obvious key advantage of joint activity is sharing of the investment risks with a partner. However, the reasons for deciding on a joint venture go far beyond simple risk-sharing. It is more a case-by-case check on what the partner can really contribute to the joint venture (apart from the initial investment) and whether this contribution is vital for the project.

One of the benefits that a local partner can bring to a joint venture is access to resources (land, production facilities, human resources etc.) and local expertise. Apart from this, the Russian partner quite often can offer market or customer access, especially in areas where the main customers for the products or services are state-controlled companies or their subsidiaries.

On the other hand, there are certain difficulties in working with Russian partners which can seriously influence joint activities. First

of all, you often need to deal with inflexible, hierarchical structures in Russian companies and, as a result, inefficiency and bureaucracy. It makes negotiations difficult for both parties and may lead to significant delays. Sometimes even minor issues cannot be resolved at the project group level, and they escalate to top management. Secondly, the language barrier is still a problem for many Russian companies. Despite the general improvement and a growing number of positive examples, language ability is often not enough for negotiation. Poor foreign-language skills in a Russian partner might cost you significant time and effort. Finally, other issues like lack of transparency and cultural differences may raise concerns.

In the end, "JV or alone?" is always a case-by-case decision. If you feel comfortable doing the project by yourself, you do not need a partner. But if you are convinced that a JV is the right thing for you, the next question is how to structure it.

Two JV structures

A joint venture project in Russia as a rule presumes a separate legal entity. Contractual JVs are rare in Russia for different reasons (in the first place, taxation and liability issues) and we will not consider them. The partners may found a JV in Russia which will perform all activities (onshore structure) or they can agree on a two-tier JV with a holding company outside Russia which will have a 100% subsidiary that is a Russian operating company (offshore structure). The holding company normally does not have any real business activity and all assets are located in Russia at the Russian operating company level.

Onshore JV in Russia

The advantages of the onshore JV are obvious: you have only one legal entity for the project. That means simplified governance and, as a result, lower administrative costs, simpler decision-making (fewer corporate approvals), in comparison to the two-tier



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offshore structure. Apart from this, there is no intermediate holding structure, and you, as a direct shareholder of the Russian company, can immediately use certain shareholder rights under Russian law with regard to the JV's operational activity (e.g. request information, challenge decisions of the corporate bodies etc.). These advantages, however, do not seem to be enough for all foreign companies investing in Russia. They often choose a foreign jurisdiction due to certain disadvantages of the simple onshore structure.

The reasons why foreign investors want to bring the Russian partner out of the Russian jurisdiction are mostly of a legal nature. Three of them that seem to be vital will be described below.

(i) Inflexibility of Russian law

Under the Russian corporate law, shareholders have limited discretionary rights with regard to the set-up and management of the company, and to a large extent have to follow mandatory rules. This also applies to shareholders' agreements. It is worth mentioning that before 2009, when the relevant amend-

ments to corporation law were introduced, shareholders' agreements where unknown to Russian law. Unfortunately, it is inherent in the Russian legal system that sometimes lack of legal regulation in a specific area leads to a lack of protection and enforceability. Corporate lawyers are well aware of the most interesting court cases on shareholders' agreements: the Megafon case and the Ruskiy Standard strakhovanie case. In them, many

legal entities incorporated in Russia. As an example, in the court cases mentioned earlier, the agreements were concluded under foreign law (one was governed by English law, two by Swedish) and in all three cases the courts applied Russian law. Hopefully, the situation will change in the future. The Russian parliament is currently considering draft amendments to the Russian Civil Code providing, among other things, for explicit

of a dispute between shareholders by the Russian court. Moreover, an arbitration award which is valid and fully enforceable in other jurisdictions may be set aside in Russia due to its violating the exclusivity of the Russian courts in corporate disputes.

Offshore JV

The key advantage of the offshore JV structure is that the parties may enjoy the flexibility of foreign law and apply best international standards of corporate governance. JV partners can choose the jurisdiction which allows them the level of comfort they got used to in their shareholders' agreements with regard to the company's management, options, dispute resolution and exit strategies, covenants etc.—and effectively enforce them. The parties may agree on appropriate dispute resolution procedures and venues. The last should not necessarily be the seat of the foreign investor. On the contrary, in order to avoid any influence or even a suspicion of influence on arbitrators, the partners may agree on arbitration in a country where neither of them is active.

Apart from the legal issues the choice of jurisdiction depends mainly on taxation and administration costs. According to the Federal statistics service, the main foreign investors in



A Joint Venture is one of the most attractive and, at the same time, more difficult forms of investment

of the provisions in the shareholders' agreements were declared invalid as being incompatible with the mandatory Russian rules. It goes without saying that both rulings had a significant negative impact and resulted in uncertainty for foreign investors.

Even after explicit regulations on shareholders' agreements were introduced in 2009, there is still a lack of positive precedent. Shareholders' agreements are seen as valid by the Russian courts only if they are within the regulations explicitly provided by Russian law. Clauses in shareholders' agreements which go beyond the corporate law provisions (even if they do not contradict Russian law but similarly regulate areas where the Russian law is silent) tend to be declared invalid in Russian courts.

(ii) Inapplicability of foreign law

If Russian law does not provide enough security, why don't the parties agree that foreign law be applicable? It is still a matter of dispute whether or not foreign law can be applied to shareholders' agreements in a Russian company. Unfortunately, the courts follow a very conservative approach, holding that Russian law should be mandatory for shareholders' agreements since they regulate the internal relations and activity of

regulation with regard to the choice of law for shareholder agreements involving foreign partners. If the law is changed it should have a positive influence on court practice.

(iii) Failing arbitrability of corporate disputes

Finally, another sensitive issue for partners is the method of, and venue for, dispute resolution. JV partners normally prefer arbitration since it is essential to ensure confidentiality, and because of the high qualification of arbitrators. From the Russian law prospective corporate disputes (the definition is still not

finally clear since the list of corporate disputes is not exhaustive) should be resolved in the Russian court of the area where the company is registered. The issue of whether corporate disputes, including those arising out of the shareholders' agreements, can be referred to arbitration is highly debatable. Although the Russian courts have not taken a uniform approach, it is a clear tendency, especially in recent decisions, to deny the arbitrability of corporate disputes. Therefore, an arbitration clause will not prevent parallel consideration

Russia (including also foreign holding companies in offshore JV structures) in 2012 among European countries were Cyprus, Netherlands and Luxembourg. Of course, these figures should be treated with caution and considered in the light of Russian realities, like active use of foreign legal entities (especially those in Cyprus) by purely Russian companies. Nevertheless, you can see the general trend.

The price that the JV partners have to pay for safety and flexibility is the cost of having a sep-



The advantages of the onshore JV are obvious: you have only one legal entity for the project

arate holding entity. It may include foundation and administration expenses, remuneration to the management of the holding company, as well as potential costs of applicable substance requirements that the holding has to comply with in order to avoid certain tax risks.

What to consider when negotiating the joint venture structure?

From the above general comparison of two JV types, the offshore structure seems to have clear advantages for the foreign investor. However, it is not always black and white. There are many factors which can influence negotiations and the choice of structure:

- Value of investment. Obviously, the more valuable the investment, the more protection it requires.
- Share in JV. Minority or majority? Generally speaking, it makes no big difference

since the main purpose is to protect your investment. But if you are aiming at a majority share and consolidation of the company, there are certainly more reasons to think about the offshore structure also in order to avoid certain requirements of Russian law that you would face in an onshore Russian joint venture, in particular Russian interested party transaction rules, which require approval by the Russian partner of any transaction or contract between the foreign investor (as interested party) and the onshore JV.

- JV partner. Characteristics of your partner also may impact on negotiations and decisions. Is the Russian company private or state-controlled? Does the Russian partner have experience with offshore structures? Does it have assets outside Russia to make enforcement possible?
- Financing. Will foreign banks be involved? An offshore structure with a holding com-

pany outside Russia often provides more security and seems to be more attractive to foreign banks when it comes to financing the joint venture.

So an offshore structure seems best for joint venture projects with Russian partners. Even more, it is often in the interest of the Russian partner as well, since offshore structures enhance security for both partners. Although the legal situation with regard to shareholders' agreements in Russia is improving, it does not provide enough protection. Onshore JVs are rather rare and may be considered as an exception, e.g. in smaller investments with a clear minority stake in the joint venture. However, neither structure can prevent difficulties arising between partners, so sole proprietorship is certainly worth considering before deciding on a joint venture.

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Galina Maier

Managing Director, Raiffeisen-Leasing

LEASING AS AN OPTIMAL INSTRUMENT FOR PRODUCTION UPGRADES AND THE DEVELOPMENT OF MODERN BUSINESSES

All enterprises, irrespective of their size, sooner or later acquire fixed assets. The list can run from office and production spaces, car fleets and production equipment to the furniture and PCs for the employees. Management has to choose the most efficient way of acquisition: to use their own funds or to attract financing. In this article I would like to show that leasing can be a financial instrument which creates additional value for a company.

First of all, leasing uses external funds and gives the possibility to organize new production, without huge investment of a company's own capital, purchasing modern equipment based on new technology and relatively quickly launching new, competitive products.

Leasing provides long-term financing, usually from 24 to 60 months. However for long-life assets, such as railway cars or real estate, the term of the lease agreement can be up to 10 years.

Lease obligations are off-balance sheet and do not increase the debt burden of a company. International accounting standards such as IFRS or USGAAP separate finance lease or hire purchase from operate lease or

long-term rent. In western Europe, operate lease has certain balance sheet advantages in comparison to the finance lease. In the current tax and legal environment in Russia, finance lease is more favourable.

For example, all lease payments are deductible for profit tax purposes and are recognized in Profit & Loss accounts as operational expenses. Leasing applies accelerated depreciation of the leased asset with a maximum coefficient of 3. It speeds up the amortization of the asset substantially and allows writing-off the asset before the end of the lease contract. This allowance has two positive effects for the lessee. The company can more quickly renew its production capacities, and it can effectively and transparently budget operating expenses.

On the other hand, if the asset was purchased directly or with a loan, only standard amortization and the interest rate in limited amounts can be recognized as operating expenses.

It is worth adding that the lessee can choose the balance sheet holder of the asset. The asset holder can be either the lessee or lessor.

With estate leasing, there is another huge economic advantage. Real estate is subject to property tax at 2.2% p.a. of the average balance sheet value. Real estate

write off the asset in 10 years.

Lease instalments are subject to VAT. The lessee will pay VAT on instalments and reclaim them during the lease term that allows



Galina Maier

Galina Maier graduated 1996 from the Geographical Faculty of the Moscow State Lomonosov University. Right after gaining her diploma, Galina participated in the Daimler-Benz International Management Associate Program and learned the peculiarities of the leasing business in the CEE, UK and Germany. In 1999 Galina joined a small team involved in establishing a daughter company of DaimlerChrysler in Croatia. At the end of 2002 Galina accepted an offer from Raiffeisenbank Serbia to prepare a Feasibility Study and organize the establishment of a leasing unit in Belgrade. Since November 2005, Galina has been managing director of the Russian company responsible for front office activities.



Management has to choose the most efficient way of acquisition: to use their own funds or to attract financing

objects can be depreciated over as much as 30 years and the owner of such an asset, whether purchased directly or with a loan, has to pay the property tax in full. A leasing company will reduce the property tax payment by three times through accelerated depreciation and the ability to

transparent and stable management of VAT inflows and outflows.

Leasing companies work closely with major producers of equipment and machinery worldwide and have a good overview of the secondary market of certain assets.

The lessee and the lessor share an interest in the minimization of the purchase price. Cooperation with the supplier gives the lessor an advantage in purchasing assets at the best market price. Often the lessor enjoys special discounts as a fleet or key account customer and has the negotiating power for further optimisation of supply terms, which suits the lessee best. Moreover, the lessor has long experience in structuring complex import contracts. If the supplier cannot deliver the asset directly to the client, the lessor can organize custom clearance and make sure customs duties and VAT are paid on time. Payments to the international supplier are often structured via a Letter of

If the client has certain ups and downs in cash flow, for example seasonal fluctuations, the payment plan of a lease agreement can take this into account.

Leasing deals foresee down-payments to cover any initial loss of value of the asset if the contract is terminated at an early stage. This should help the lessor minimize losses if the asset has to be sold on the second-hand market.

I would also like to mention that a leasing company has the right to sell repossessed assets to any independent buyer and is not obliged to organize an auction. This flexibil-

The lessee can get a wide range of additional services. For example, the maintenance of the asset can be agreed during the contract term, fuel cards can be provided as well as roadside assistance. Alternatively, the lessor can rely on its own service or can have agreements with major service providers.

It is very important to consider asset insurance. All leased assets should be properly insured. Lessors work with all the large insurance companies and enjoy special tariffs. Insurance through the lessor gives the client a big price advantage. Leasing companies have special treatment when adjusting losses if an insurance claim is made.

The wide use of leasing will help modernize the Russian economy. Production capacities in Russia in many sectors are very old, so there is a huge investment demand for modernization and the growth of the production.

International statistics show that leasing is one of the most important financial sources for the renewal and growth of production. The share of leasing services in the overall investment in fixed assets is 20-30% in developed countries. The share of leasing in Russia is less than 15%. In the year 2011, it was 12%.

The use of leasing services will facilitate the replacement of equipment and production technology and increase efficiency, while at the same time reducing companies' capital requirements and improving the quality of finished goods. As a consequence of all this, it will help to improve the output of the national economy.



Leasing deals foresee down-payments to cover any initial loss of value of the asset if the contract is terminated at an early stage

Credit. The lessor has often better conditions and enough financial leeway to cover such transactions.

The main motto of the leasing industry is "pay as you earn". Lease payments are due after the delivery and putting the asset into operation. That gives the lessee enormous economic advantage. Such an approach is of great importance for small and medium-sized enterprises, as well as for the start-ups.

Leasing is an ideal instrument for the SME sector. Many SME customers have difficulty attracting financing. The time necessary to get approval is long but the term of financing is usually short. If the decision of a bank is positive, additional securities can be required. The leased asset can often be the only security for a deal, if the legal owner of the asset during the whole lease contract is the lessor.

Leasing companies are usually able to be more flexible in structuring payment plans.

ity is advantageous for the lessor as well as for the lessee, because it helps to achieve a good sale price in a shorter time and possibly reduces the debt of the defaulting customer.

The regular termination of the finance lease contract does not foresee any residual value; the selling price at the end of the contract is symbolic due to the full pay-out nature of the agreement. The asset is fully depreciated during the lease and the lessor transfers ownership of the asset to the lessee after all contract obligations have been fulfilled.

If the client does not intend to become owner of the asset and is willing only to use it for a certain period of time, the operate lease structure is an ideal instrument. Such long-term rent is widely used for car lease, truck and trailer lease, and IT equipment lease. For such contracts the residual value is calculated depending on the contract term and the agreed intensity of use—for example, driven kilometres for a car.

Bruno Metz

General Manager, RH PARTNERS Russia

OUT-STAFFING: THE EASY WAY TO LAUNCH IN RUSSIA

It is an accepted fact that starting a business in a foreign country is a greater challenge than it is at home, certainly from an administrative point of view. As with other countries, Russia has its own laws relating to corporate administration, accounting, and HR. The byzantine, and often contradictory, nature of these regulations makes outsourcing non-strategic issues to a local partner often the best solution for a company new to the Russian market.

Out-staffing companies specializing in startups can play a key role in the success of a new market entrant. Such partners can take on administrative liability, freeing your company from legal concerns, and design/implement robust HR policies that will provide security and compliance within the Russian corporate environment.

Out-staffers can recruit and retain employees who meet your specific requirements, as well as handling all hiring and registration

tration, income and social tax payments, and travel expense administration. The latter is far more complex in Russia than in most Western countries, as the rules for what can be deducted and in what amount can be baffling. Some out-staffers can even manage daily expenses such as office supplies, and provide PCs, mobile phones, car leasing, fuel cards, insurance, etc.

Typical out-staffing companies will share high-level administrative staff among several clients, yielding significant cost savings for all parties. Such arrangements typically provide that each participant pays only for specific services utilized, resulting in an economic “pay-as-you-go” approach. Thus a newcomer to the market can benefit from highly qualified HR and administrative personnel without having to recruit and employ expensive in-house staff.

Reputable out-staffers are naturally incentivised to provide the highest quality marketing and legal advice to their clients, as they are legally responsible for advice given and actions undertaken on behalf of clients.

Out-staffing clients typically benefit from special rates on insurance, car leasing, and office rental, as service providers often enjoy volume discounts based on their work with many companies.



Out-staffing companies specializing in startups can play a key role in the success of a new market entrant

formalities. Sometimes the ideal solution will involve a subcontracting arrangement under which the worker remains officially employed with the out-staffing company and simply provides services under a temporary labour agreement. The out-staffer provides all HR documentation, including labour contracts (required by law in Russia), payroll adminis-

Out-staffing reduces up-front market-entry expenditures and therefore mitigates risk in the event that the head office decides to change strategy or even leave the market.

The most important advantage of out-staffing is simple: by freeing your managers from the red-tape and the complexities of Russian la-

**Bruno Metz**

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bour law, they can focus on the company's core business, secure in the knowledge that legal and compliance issues are under control.

Out-staffing companies typically earn a fixed percentage of the costs they generate, ensuring that the cost to clients is kept in line with real expenditures.

If the client is not ready for cross-border invoicing, which can be tricky, invoicing can be done through a distributor or low-cost SPV set up expressly for this purpose. All such arrangements are of course in full compliance with the requirements of Russian law.

Out-staffing will be an advantage to your company if:

- You are looking to develop sales in the Russian market but have doubts about the

overall potential;

- You are considering opening, but not yet ready to open, a local subsidiary;
- You wish to minimize costs and risks as you explore new markets;
- You want to avoid the commission and cost burdens typically associated with recruiting companies;
- You wish to minimize your company's legal responsibility to employees while still complying with the Russian labour code;
- You need to hire highly qualified specialists for time-limited projects;
- You want to reduce regulatory risk;
- You want to test employee performance longer than is allowed by Russian trial period legislation.

Out-staffing benefits in Russia include:

- Strong relationship with a competent and

reliable partner and mediator for all HR and payroll issues, with the tax authorities, social and pension funds, etc.;

- Ability to launch in Russia in minimal timeframes and at minimal cost;
- Freeing key personnel from administrative details, permitting them to focus on core business issues quickly;
- Freeing management from issues not connected with sales or growth of company value;
- Enhanced competitiveness;
- Alleviation of the need for HR or accounting departments which would otherwise be required under Russian law;
- Reduced liability to the tax authorities, labour authorities, and the migration service;
- Utilization of expert knowledge and long-term experience in recruiting;
- Significant savings in salary costs, staff

costs, and administration expenses;

- Ability to employ temporary staff for specific projects;
- Greater leeway in discharging (firing) employees without violating Russian labour laws;
- Advanced HR and payroll administration tools, software, and systems expertise.

Out-staffing has proven itself as one of the most popular and cost-effective approaches to market entry in Russia. There is no need to "reinvent the wheel" when setting up operations in a new market with complex rules. Successful companies will outsource these functions to professionals, allowing their own resources and energy to be focused on core business development, while a reliable partner manages the administrative minutia required by Russian law.

CASE STUDY: A START-UP PROJECT

About the client

The Client in this case study is a leading international company specialising in high-performance hydrostatic transmissions. The company was founded in 1926 and currently has eight production facilities around the world as well as a presence on three continents. It is seeking to develop sales in new markets with the best growth potential.

The goal

The company operated for some time through distributors but made a strategic decision to start its own operation in Russia in order to improve sales, image and service. The objective as presented to the out-staffer was to quickly develop an effective HR solution involving recruitment of highly qualified hydraulic specialists to manage the new Russian operation. Positions to be filled would include Project Manager, Sales Manager and personnel, Technical Support Engineer and support specialist, as well as a sales administrator. The goal was to create and register a fully functional legal entity which would control all sales in Russia within two years.

Project execution

Project implementation included the following steps:

- Out-staffer developed and approved a complete operational hierarchy, identifying all key management and support personnel required to launch and operate the project.
- Within a month the out-staffer recruited and assigned the project manager who would eventually become Managing Director of the Client's Russian subsidiary.
- Over a three-month period the out-staffer identified, interviewed, and hired all other candidates needed to fill the personnel tree. These included several technical sales managers, the technical support engineer, a business & sales administrator, and a number of other positions, all with varying degrees of expertise in the hydrostatic field.
- Personnel was originally employed by the out-staffer and seconded to the Client.
- HR management, record keeping, payroll and travel expenses were all outsourced to the out-staffer.
- All operating expenses were managed by the out-staffer.

- As soon as the Client was registered as a legal entity, all core employees were transferred from the out-staffer's payroll to the Client's payroll.

- The out-staffer continues to follow and manage on an ongoing basis all HR operations, payroll, bonuses, travel expenses and operating costs. Economic analysis shows this to be less costly and more efficient as in-house management within the Client's company.

Results

- Comprehensive solution to the Client's business objectives;
- Successful sales development as the Client's team focused exclusively on core business issues;
- Recruitment and hiring of loyal, trustworthy core employees, with zero personnel turnover in the first year;
- Significant reduction of legal risks due to outsourcing of HR functions.

Alina Lavrentieva

Ph.D, Partner, PricewaterhouseCoopers Russia

PRIVATE AND FAMILY-OWNED BUSINESS: A RESILIENT MODEL FOR THE 21ST CENTURY

Since the days when Rémy Martin distilled his first bottle of cognac and William Procter founded several soap and candle factories, things have changed dramatically in the private and family-owned business sector. In the global PwC Family Business Survey 2012, we interviewed over 2,000 owners and managers of private and family-owned companies from 30 countries, including Russia. This was the third such survey since 2007, and the latest edition is the most comprehensive to date. It aims to show how managers of private companies assess their business in terms of efficiency, as well as what challenges they face and how much long-term vision they have.

Growth through overcoming challenges — what's the secret?

The survey results show that private and family-owned companies are resilient, vigorous, ambitious, and successful in the business arena, and are experiencing rapid growth both in Russia and the rest of the world. Last year, 65% of private companies globally saw increased sales, while Russia's private businesses have done even better with 92% reporting growth. Furthermore, private companies are looking to the future with confidence. Over 80% of private companies, including in Russia, believe that their business will enjoy stable growth over the next five years. Considering the low level of confidence in other sectors of the

economy, this is compelling evidence that private business will play a significant role in creating new jobs and driving economic recovery.

But, as with any other business, private and family-owned companies are not immune to the global economic slowdown and must deal with many of the issues that other companies face. Most of our respondents noted three key external issues: market conditions, competition, and government policy and regulation. The main internal issue facing most companies remains recruiting and retaining skilled personnel. Russian respondents also noted the availability of financing and the level of profitability as some of the most relevant internal growth-related issues.

So, what is it that helps private and family-owned companies to meet these challenges and look to the future with confidence? Survey respondents were very diverse in terms of company size, and the regions and industries where they operate. But, what they all have in common is their approach to doing business and what they see as the distinctive features of private and family-owned companies. These include an entrepreneurial mind-set, the capacity for big-picture thinking and a long-term outlook, faster and more flexible decision-making, a higher level of responsibility for creating and preserving jobs, and respect for the interests of local communities. Private and family-owned companies believe that these distinctive features give them a significant competitive edge, and represent an integral part of their business model. At the same time, however, it is also clear that some other aspects of this business model could act as a brake on a company's growth, give rise to internal conflicts, or force a business to avoid risks altogether.

Grounds for concern

Most private and family-owned companies monitor their debt liabilities very carefully and instinctively shun the active use of le-

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Prior to PwC Russia, Alina was the Finance Manager of a large multinational company, and worked for a professional firm of advisors.

Alina is the chairperson of the Taxation Committee of the Association of European Businesses in Russia.

verage. And, only a handful of companies can offer the sort of equity participation that outside partners seek. Under such circumstances, the pace of growth among private and family-owned companies could be slower given the low level of debt financing.

Knowledge and skills is another area of concern for private and family-owned companies. Our survey clearly revealed that the ability to identify, assess and control risks is a skill that private and family-owned companies must develop. Survey respondents also noted the need to expand their knowledge in such areas as information technology, intellectual property, and more targeted and strategy-oriented approaches to business management. Likewise, particular attention should be paid to innovation and compliance requirements. It should be noted, however, that private and family-owned companies in Russia are less concerned about

innovation-driven growth and compliance issues than their global peers. For Russian companies, the primary issue remains recruiting and retaining skilled personnel.

And, of course, economic issues remain an area of concern, including globalisation and especially Russia's accession to the WTO. Russian respondents also pointed to consolidation, an increasing number of acquisitions and aggressive competition from major multinational corporations, and growing pressure from government as factors that will challenge private business in future.

Business and the wider community

In our survey, we asked private and family-owned companies whether they feel the government values the contribution they make. We also asked what needs to be done for private business to enjoy government support. The survey results indicate that regardless of their size, industry or region of operation, private and family-owned companies highly value their own contribution to the economy. But many respondents believe that the governments of their countries undervalue or even overlook their efforts. Russian survey participants also feel that they are at a disadvantage versus state-owned companies, and are dissatisfied with this state of affairs.

They seek fair competition, along with a fairer tax regime and less corruption. Russian respondents indicated that, for them to operate more efficiently, a system must be put in place that offers a level playing field and equal opportunities for both private and large-scale (including state-owned) companies. Fair conditions for private business must be ensured, and private business must be respected and encouraged to grow through providing access to affordable financing. Regarding general barriers, Russian survey participants noted the need to eliminate bureaucratic red tape, such as excessive reporting requirements, as well as to establish an independent and impartial judicial

system, root out corruption and corporate raiding, and develop a transparent, predictable and business-friendly tax regime.

Values and conflicts

Most survey respondents (78%) believe that private and family-owned companies have a strong internal culture and system of values, which play a greater role than in other types of companies (public or state-owned). In addition, respondents are confident that their employee relations and social initiatives are marked by the highest level of responsibility. In this context, a highly critical issue for the heads of private and family-owned companies is transitioning their business to the next generation.

Building a culture of business management among successors and transforming family values into business values can create the necessary grounds for continuing the legacy of a pioneering entrepreneur's success story through building a success story for his entire family. The owners of any company are naturally concerned about the smooth transition of a private or family-owned company to the next generation through identifying family members who can take on leadership roles, settling conflicts among family members and fostering a culture of cooperation among them.

Most survey participants indicated that they have taken specific measures aimed at settling conflicts and ensuring adequate succession planning: including shareholder agreements (49%), an action plan for the owner's disability or death (37%), investment and going-out-of-business procedures (28%), and family constitutions (19%), among others. Some respondents (32%) also reported taking formal measures aimed at assessing the performance of family members employed within the company. In interviewing executives of Russian companies, we learned that shareholder agreements are the most common tool used to settle disputes and conflicts among the

owners of private companies. It's noteworthy that 39% of Russian private companies currently have no procedures in place for conflict resolution or succession planning (versus 21% globally), however.

Looking to the future

At the heart of many private or family-owned companies is the expectation that the business will be passed on from one generation to the next. Indeed, the survey showed that 41% of respondents plan to transfer ownership and management of their business to the next generation. Notably, however, over 50% of these respondents still expressed doubts about whether the successor generation has the requisite knowledge, skills and drive to successfully move the business forward. Most Russian survey participants (57%), however, stated their intention to sell their businesses, indicating various reasons for their reluctance to pass the business on to the next generation. These include uncertainty about future economic and political conditions in their countries, and the lack of qualifications among successors, or their unwillingness or unreadiness to go into business, as well as doubts about whether private businesses can rely on adequate government support.

Overall, the results of this year's survey clearly show that private and family-owned companies are a dynamic and vital element of the global economy, and that they can contribute even more to promote future growth if they receive the support they need, when they need it.

Max Gutbrod

Partner, Baker & McKenzie

M&A WITH A VIEW TO BECOMING A LOCAL SUPPLIER IN RUSSIA: OPPORTUNITIES THROUGH THE ARRIVAL OF OEMs IN RUSSIA

In the early 1990s, it was natural for international companies to think about joint ventures (JVs) with the former Soviet "kombinats". The technology that existed in the Soviet economy frequently was better than expected. Russians, hoping to be able to catch up with world markets, at least partially welcomed foreign experience. However, soon enough legal advice focused more on how to deal with surprises when JVs went going wrong, and how to soften the acrimony of related disputes.

As an example, what can be done if primary and secondary markets of car suppliers could not, as in other parts of the world, be separated, because primary market customers could not be trusted not to resell spare parts? Or how to close a loss-making plant that had been run by an irate minority shareholder for some time? The Russian kombinats would, mostly unsuccessfully, in the meantime, have tried to compete in access to the final customer, for instance, by producing new passenger cars. Even when they had bought technology from the West, they would continue to use parts that were produced by suppliers that were part of the very kombinats (the so-called captive suppliers). In other words, their vertical integration continued to be very high, and predictably the success in the market limited. Those

developments were most easily visible in the automotive industry, but, in a similar manner, also happened in the agricultural machinery, the chemical and, to a certain extent, the steel industries. In the end, the conclusion was that the expectations of the parties differed too much for JVs to make sense.

Now, it appears to be time to again revisit the usefulness of JVs. The surviving successors of the former Soviet kombinats have woken up to the fact that their vertical integration still is so high as to endanger their competitiveness against world market leaders. Some corporate histories have shown that a late transition to competitive enterprises can be risky. For instance, a major Russian tire producer, after having bought a western European competitor and done an IPO in 2005, ran into financial difficulties from which it did not recover.

Most of the Russian automotive giants have sophisticated JV strategies in place or are at least open to considering JVs. A key driver for this is that, from the perspective of the Russian companies, one of the key reasons for making decisions is that political trouble when dismissing employees can be avoided. This in turn can now be an attraction to the relevant investor as skilled workers are not abundant in places like Kaluga. Also, there is a chance, when transferring long-term employees, of acquiring the in-built knowledge and access to old technologies that are no longer available elsewhere.

In many cases, there is no need for overly high investment. In some cases, it is also possible to profit from investments been made by the Russian partner which had been more focused on the quality of the equipment than on bringing advantage in markets.

Frequently, Russia does not display its wealth in resources to the investor, but rather makes it difficult to access electric-



Max Gutbrod

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ity and other essential supplies required. As existing factories will have ongoing relations with suppliers, energy is not as much of an issue as when setting up a new production facility. Additionally, access to some goods, like steel, when bought locally and without the transport and other logistical costs that would elsewhere arise, can give an easy competitive advantages.

It is important to have access to a purchaser community for the manufacturer of spare parts that would otherwise be very difficult to build. By way of an example, if a vertically integrated kombinat ensured that all supplies are made through it only, there may well be a chance of access to a market that would otherwise require years of work to open up. There is only a limited time in which manufacturers have to comply with local content requirements and therefore are specifically interested in suppliers also manufacturing in Russia. Imagine, for in-

stance, the potential of working together with a well-established manufacturer of buses or trains. Needless to say, success in local markets requires good contacts with municipalities, in the case of the buses, and Russian Railways, in case of the trains. A partner having that would be ideal for negotiating off-take guarantees or at least rights of first offering goods in a manner that, when used at the right time, could allow for a significant improvement in relevant market share.

Accordingly, one of the key issues is that targets should be quickly identified. Whilst, typically, suppliers will have ongoing contacts in an industry, the best way to approach joint venture negotiations will not be known by the existing staff, but easily available through specialized consultants. Discussion with them should also allow a relatively quick assessment of the viability

of the chosen approach, agreement on a negotiation strategy and establishment realistic time-lines.

Deployment of resources at the negotiation phase is important as sales contracts need to be synchronized with the setting up of the local production facilities. An important part of the negotiations is the valuation of property. This used to be difficult when Russian counter-parties held unrealistic expectations. It is now easier because the Russian counterparty will tend to focus on the profit of the JV instead of trying to generate revenue quickly. The Russian side will typically want to have a share close to 50%. To ensure stability of shareholders relations, an offshore vehicle (Cyprus, Swiss) for the joint venture will be set up. A schedule of management functions as typical for shareholders' agreements will frequently be agreed at

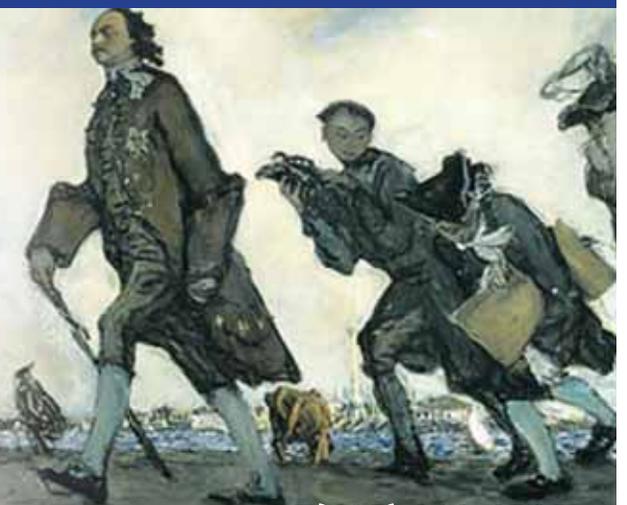
the start. This will be easier than it used to be because staff with experience working for international companies is now readily available for most functions. Given that negotiations in such contexts have now become routine, it is much more likely that the negotiation process will comply with expectations.

In countries like Brazil, the advent of the car manufacturing suppliers in the '60s and '70s of the last century changed the industrial climate completely and irreversibly. In Russia, this process is starting now and, as in Brazil, it is bound to have significant impact on the economy, and to present major opportunities.

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**REGIONAL ASPECTS
OF INVESTING
IN
RUSSIA**

PART III >>

Asel Isakova

Senior Economic Analyst, the Office of the Chief Economist at the European Bank for Reconstruction and Development in London

THE REGIONAL BUSINESS ENVIRONMENT IN RUSSIA: EVIDENCE FROM AN ENTERPRISE SURVEY

We tend to think of the business environment as a country characteristic. In fact, one often tends to compress it to a single number, a country-ranking for instance. Russia is ranked 112th in the 2013 Doing Business report, an improvement of eight positions over previous years thanks to streamlined tax administration procedures.

At the same time, many key aspects of the business environment depend on regional and local legislation and on implementation of country-wide reforms at regional level. For instance, local authorities are usually responsible for construction permits and issues relating to access to land. Further, regional and municipal governments account for approximately half of consolidated government spending in Russia. They are primarily responsible for key public services, such as health-care and education. The regional dimension is thus very important when understanding and assessing the business environment.

To get a better understanding of business environment issues, the European Bank for Reconstruction and Development (ERBD) and the World Bank regularly conduct Business Environment and Enterprise Performance Surveys (BEEPS). These involve face-to-face interviews with enterprise managers and examine the quality of the business en-

vironment as determined by a wide range of interactions between firms and the state.

To date, four rounds of the survey have been conducted in emerging Europe and Central Asia (1999, 2002, 2005 and 2008-09). Similar enterprise surveys have also been conducted in over 100 developing economies by the World Bank Group, providing fully comparable information and business data for all these economies.

The key objective of the BEEPS is to gain an understanding of how the business environment affects firms' operations. The BEEPS covers topics such as infrastructure, competition, sales, supply of inputs, labour, innovation, access to land, permits and certificates, crime, finance and business-government relations. It also collects characteristics of enterprises and their decisions regarding investment, employment, and sales. This helps to link the nature of the business environment to economic outcomes such as the growth and productivity of enterprises.

The survey also collects subjective opinions of the business environment. Namely, managers express their views as to what extent various components of the business environment, be it access to electricity or lack of skilled personnel, are seen as obstacles to the operation and growth of their business.

The fifth round of BEEPS in Russia was launched in August 2011, in cooperation with the Ministry of Economic Development, the Centre for Economic and Financial Research at New Economic School (CEFIR), and with support from the EBRD Shareholder Special Fund and Vnesheconombank (VEB).

For the first time the survey includes representative samples of businesses in 37 of the 83 regions of Russia, across all federal districts. In total, more than 4,000 randomly-selected enterprises were surveyed. In each region the surveyed firms include small, me-



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dium-sized and large enterprises, operating in the manufacturing, wholesale and retail trades, transport, construction, and other service sectors.

The new BEEPS thus provided a unique opportunity to get insights into the perceived quality of the business environment in Russia's various regions. However, interpreting results of a survey such as BEEPS is not straightforward.

One difficulty lies in the fact that respondents to the survey may have different standards in defining a "major obstacle" constraining their business. And firms may differ in their willingness to complain about problems like getting an electricity connection.

Another difficulty is related to the fact that characteristics of firms responding to the

survey may affect their demand for certain public goods and impact on the level of quality that they expect from the business environment. Customs matters much more for firms that export or import than for firms that only work with domestic counterparts, while manufacturing firms may have a higher demand for transportation services than IT firms.

To address these problems, one can look at firms' answers for a particular constraint, such as business licensing, relative to all other answers, thus controlling for "propensity to complain". One can then try to explain the answers using various observed characteris-

tics of the firm, such as industry or exporter status and use the "unexplained", residual, component of firms' answers. These residuals reflect the business environment quality as perceived by a representative firm: a privately-owned manufacturing firm with around 20 employees which sells in the domestic market and is led by a male chief executive officer who has been with the firm for around six years.

from the informal sector, access to physical infrastructure, access to land and tax administration. Table 1 reports the three most binding constraints as perceived by representative firms in each of 37 regions. Nationwide—tax rates apart—corruption, access to finance and shortage of skills emerge as the top three constraints to doing business. However, in no region are they replicated in that order. In fact, in some regions, firms complain about elements of the business environment that do not, on average, rank highly as constraints in the country as a whole.

For example, in the Primorsky region access to land is the most binding constraint, while

elsewhere. But it does suggest that given the profile of firms and business environment in the regions, improving transport infrastructure can yield largest benefits in Leningrad region and Khabarovsk region, while improving access to land should be a priority in Primorsky region.

In regions around Moscow, workforce skills are among the most severe constraints to doing business. This does not necessarily reflect the objective quality of human capital in these regions and may be largely due to the proximity of regions such as Tver or Yaroslavl to Moscow and the impact that this megalopolis has on local labour markets. An important exception is the Kaluga region, where skills do not appear to be more of a constraint than elsewhere in Russia. This may reflect the initiative of the local authorities to attract and retain skilled labour as well as vocational training programmes set up jointly with private investors.

Enforcement of federal reforms also varies by region. For example, a series of laws was passed between 2001 and 2004 that lim-



Many key aspects of the business environment depend on regional and local legislation and on implementation of country-wide reforms at regional level

tics of the firm, such as industry or exporter status and use the "unexplained", residual, component of firms' answers. These residuals reflect the business environment quality as perceived by a representative firm: a privately-owned manufacturing firm with around 20 employees which sells in the domestic market and is led by a male chief executive officer who has been with the firm for around six years.

This type of analysis does not directly reveal if the overall business environment in one region is better than in another. It however can indicate which constraint is regarded by a representative firm as being more problematic in a given region, given other constraints and given firms' demand for various components of business climate.

Overall, the results reveal substantial variations across the regions in terms of the quality of the business environment. The differences are particularly large in areas of competition

it only appears among top constraints in two other regions. The Kaliningrad region is the only region where trade regulations and customs were among the three top constraints to conducting business—perhaps unsurprisingly, given its enclave location.

The survey also suggests that firms in the neighbouring regions can often face very different constraints to their activities. For instance, in the Khabarovsk region firms are most concerned about the supply and quality of the physical infrastructure: transport, access to electricity and telecommunications. At the same time none of these constraints features prominently in the regional business environment "profile" of the neighbouring Primorsky region, where competition from the informal sector and corruption are among the top obstacles in addition to access to land. Transport infrastructure also tops the list of concerns in Leningrad region. This does not imply that infrastructure in Leningrad region is objectively worse than



Enforcement of federal reforms also varies by region

ited the number of scheduled inspections, abolished the majority of license requirements and introduced a "one-stop shop" for company registration. A new study by Ekaterina Zhuravskaya and Evgeny Yakovlev finds, however, that enforcement of these laws was incomplete and varied by region. Even several years after the law was passed the majority of licenses obtained by small firms had no legal basis. The firms nonetheless found it easier to comply with such demands than to contest them. The study further found that liberalisation reforms were enforced to a greater extent in regions

with a greater transparency of governance. Ensuring that liberalisation reforms are not only passed but also effectively implemented at the regional and local levels remains a challenge.

Interestingly, in virtually all regions, firms that innovate, i.e. introduced a new product over the last three years, feel more constrained by poor business environment than firms that do not innovate. The differences between the answers of innovating and non-innovating firms are most striking with regard to skills, customs and trade regulations and corruption.

To have more innovation, Russia clearly needs a better business environment, which means a better business environment in the regions. Here the regions could perhaps learn from each other's strengths and successes through peer-to-peer exchanges. Surveys such as regional BEEPS and Doing Business Sub-national can help to raise awareness of such strengths and weaknesses.

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Top business environment constraints by region



Dmitry Ryabov

CEO of OJSC "Ulyanovsk Region Development Corporation"

CASE STUDY: THE ULYANOVSK REGION

Key characteristics

- Area: 37.2 thousand km²
- Population: 1.3 mln.
- Regional centre: Ulyanovsk
- Labour resources: 807,200

The Ulyanovsk region is situated in the south-east of the European part of Russia, in the centre of the Volga region, lying about 875 km from Moscow. Its advantageous geographic location in the centre of the industrially developed and densely populated Volga Federal District makes the region an attractive hub of federal and international logistics routes. Within a radius of 500 kms there are 47,000 industrial enterprises producing 15% of the industrial product of Russia. The main industry in the region is machine building. The leading branches are the aircraft industry, the automobile industry, machine tool construction, heavy power generation equipment and the transport engineering industry.

Today a unique system of support for investment and a favourable investment climate have been realised in the Ulyanovsk region, after seven years of intensive work. This is supported by assessments from world experts.

According to the international rating "Doing Business in Russia-2012", prepared by the World Bank and the International Finance Corporation in 2012, Ulyanovsk took first place among Russian cities as far as conditions for doing business was concerned.

Andrey Belousov, former Minister of Economic Development of the Russian Federa-

tion, has said: "The best thing to do would be to transfer the capital to Ulyanovsk because it is an absolute winner in the rating. In that case, thanks to this act, Russia would immediately move from the 112th to 70th place in the rating in different countries in Doing Business."

The Ulyanovsk region is among three most favoured regions for German investments, according to results of surveys of the popularity of Russian regions among German businessmen, conducted by Russian-German Trade Chamber in 2012.

These enviable results have been achieved thanks largely to the fact that the government of the region has put its hopes in attracting investment. The volume of investments increased between 2004 and 2012 six-fold, from 285 million to 1.825 million Euros. Such foreign companies as SAB-Miller, Mars, Henkel, Takata, Quarzwerke, Gildemeister, Jokey, Schaeffler, Pilkington, Hempel, Fresenius Medical Care, Legrand, Hilton and McDonald's, and also large Russian companies like Mordovcement, Eurocement, Sollers and PM Packaging have come to the region.

The system of cooperation with investors

The region has created a so-called "development bloc" which includes high-profile ministries and departments of the government of the Ulyanovsk region, in particular the Ministry of Strategic Development and Innovations and other bodies outside the government. First of all, in 2008 the Ulyanovsk Region Development Corporation was created, bringing together a team of professionals who efficiently support investors coming into the region, and creating conditions for their success. The Corporation is a single "dispatcher", which cooperates with investors at every stage of investment project realization: from initial negotiations to putting a plant into operation.



Dmitry Ryabov

Born on 2 October 1976 in Ulyanovsk. In 1998, Dmitry Ryabov graduated from the Ulyanovsk State Technical University's Organization Management Department. In 2001, he finished postgraduate studies in Management of the National Economy. Mr. Ryabov started his career as a self-employed businessman, and then was appointed director of several commercial enterprises. From 2006 to 2008, he was the Minister of Investments and External Relations of the Government of the Ulyanovsk region. In 2008, he was appointed Deputy Chairman of the Ulyanovsk Region government. While there he was put in charge of regional enterprise, investment and tourism policy. From 2009 to the present, Dmitry Ryabov has been the CEO of the regional development institution OJSC "Ulyanovsk Region Development Corporation".

The system of cooperation with investors operates on a standard scheme and includes preliminary negotiations, detailed discussion of technical and financial conditions for project realization, the signing of an investment agreement, preparation for construction, construction itself and plant commissioning.

Applying to the region and negotiating

Negotiations are the first step for every company. An investor can apply to the Corporation by telephone or e-mail, through the official website of the Corporation by an on-line inquiry or through the official representative office of the Ulyanovsk region in

Moscow. In addition, in February 2013 a representative office of the Ulyanovsk region for our foreign partners and potential investors was opened in Germany (Berlin).

Thus, independently from a chosen way of applying an investor turns to the Corporation. The work with foreign and Russian investors is divided into separate divisions within the Corporation. Each subdivision works with investors individually, providing a detailed offer for every project and ensuring its full support. Participants at all levels — directors of high-profile departments of the Corporation, its CEO, high-profile ministers and the Governor himself — are all involved in the negotiation process.

After applying to the Corporation, an investor will receive comprehensive information about the Ulyanovsk region, options for production sites, and technical and financial aspects of project realization in the region. Following the requirements of current legislation, we do our best to reduce the time-scales and minimize investors' expenses while "entering the region". At each stage we control the process of project realization, and examine risks if they appear. Our distinctive feature is that the Corporation was established entirely with state capital, so we don't have any commercial interest. Our task is to create new

method is through visits of a working team from a potential investor to the region. That enables an investor to inspect a variety of potential sites, conduct meetings with supplying companies and recruiting agencies, and also to discuss conditions of doing business in the region with representatives of companies which have already made investments in the Ulyanovsk region. This helps an investor understand that the whole process is organized, and see that everything is transparent and clear.

From its side, the government of the Ulyanovsk region participates in every stage of negotiations and continually supervises the process of preparation for construction and construction itself. The whole process of investment project realization is under the personal control of the governor, and consequently is provided with a full range of administrative support. For the investor's convenience, all contacts at all stages of project are made only through the Ulyanovsk Region Development Corporation.

The economic system of support of investment projects

All arrangements regarding the financial, technical and time aspects of a project reached during negotiations are recorded in an investment agreement, which is signed between the government, the investor and

the provision of tax incentives.

Today a unique financial environment for investors exists in the Ulyanovsk region. Under the current law, an investor does not actually pay taxes on income, property and transport to the regional budget for 10 years, and for the following 5 years taxes are paid at reduced rates. This 15-year "tax holiday" allows the investor to save from 30% to 50% of the total expenditure invested in a project. Regarding the Corporation, the investment agreement fixes the obligation on provision of the land plot and timely provision of infrastructure for it.

Localisation in the region

When making a decision to locate production in the Ulyanovsk region, an investor can choose either a greenfield site, a non-occupied land plot provided with all the necessary infrastructure, or a brownfield site, which is a prepared production facility, or on a "built-to-lease" (or "built-to-suit") basis, accommodation in a building built in accordance with the requirements of the investor, on lease terms. Nowadays in the Ulyanovsk region there four industrial parks, "Zavolzhye", "Karlinskaya", "Novoulyanovsk", "Novospasskoye", and a Special Economic Port Zone.

"Zavolzhye", which covers 623 hectares, was opened in 2008, one of the first certified industrial parks in Russia. It is fully provided with the necessary engineering infrastructure and facilities: electricity, gas, water, sewerage and storm drainage, roads and railways, and telecommunications. The park meets the requirements of all existing and potential residents. All land plots within the industrial zone are owned by the Development Corporation and therefore can be directly purchased by an investor under a buy-sell agreement.

We have carried out all the environmental, geodesic and geological surveys of the sites in the industrial zone so we can guarantee their legal and ecological safety.



Today a unique system of support for investment and a favourable investment climate have been realised in the Ulyanovsk region, after seven years of intensive work

production facilities and work-places, and to increase the tax base.

The negotiation stage includes working meetings with management and specialists from potential investors both in Russia and abroad. Undoubtedly the most efficient

the Corporation. The government's obligations under the agreement, as a rule, consist in providing administrative support at each stage of the project, from obtaining the necessary permits and approvals prior to the plant's start-up and during the entire period of the operation of the plant, as well as to

Currently, within "Zavolzhye", projects are being implemented by twelve companies, mostly of foreign origin: SABMiller (EFES, brewery), MARS (placed 2 plants in the region — pet food and confectionery production), TAKATA (production of automotive safety systems), Gildemeister (machine-tool production), Jokey Holding (production of plastic packaging), Schaeffler Group (production of automotive and

anovsk region. In particular, there are two specialized areas on the basis of existing facilities, industrial parks "DAAZ" and "UAZ". For example, the Japanese company KOITO, the world leader in automotive lamps and optics, has sited its production on the park "DAAZ", located in Dimitrovgrad in the Ulyanovsk region. Dimitrovgrad has a very favourable geographic location in relation to its core customer, OJSC "AvtoVAZ", which

documentation and, if necessary, implementation of the control function at the construction site, thus providing support in a "single window" regime. However, the investor is completely independent in the selection of suppliers and contractors.

Personnel

One of the main advantages of the Ulyanovsk region in comparison with many other regions of Russia nowadays is the fact that it has an impressive personnel reserve to meet the labour requirements of existing and future enterprises. Annually, 17 universities and 35 secondary vocational schools educate more than 74,000 students, producing highly qualified new employees and work specialists.

Companies investing in the Ulyanovsk region have the opportunity to actively participate in the process of personnel training for their enterprises. In terms of cooperation with investors and educational institutions in the region we create training centres for training and re-training to the needs of specific enterprises. For example, the German company, Gildemeister, plans to create a regional training centre where all the competencies required for production of high precision machines will be centred.

Dr. Ruediger Kapitza, CEO and Chairman of the executive board of Gildemeister AG says: "Our enterprise in the Ulyanovsk region will be the newest and, accordingly, the most modern production facility of our firm in the world. We will establish training centre there. We consider the region possesses a high level of personnel training and, of particular importance for us, of technical specialists. In cooperation with the government of the Ulyanovsk region we plan to integrate into the facility the educational institutions of the region where we will train up to four thousand young people annually."

Social infrastructure

We understand the importance of an ap-



The logistical position of the Ulyanovsk region provides optimal transport routes and profitable logistics for the supply of raw materials

industrial components) and Pilkington (energy-saving glass production). Many of these companies chose the Ulyanovsk region for their first production plants in Russia. A recent achievement is the investment agreement for car tire production, signed the 12 April 2013, with two companies of worldwide reputation: the Bridgestone and Mitsubishi Corporations. The plant in Ulyanovsk will be one of the largest car tire production centres in Russia.

On the opposite bank of Volga River, we are developing a new industrial park, "Karlinskaya", where companies will be offered green-field sites as well as built-to-suit locations.

Brown-field sites are selected, as a rule, by the manufacturers of automotive components. The logistical position of the Ulyanovsk region, surrounded by the major machine construction centres in Russia, provides optimal transport routes and profitable logistics for the supply of raw materials for the production of automotive components, as well as for the delivery of finished products to the car assembly plants of Russia. With the assistance of the Development Corporation, automotive component manufacturers can easily find a suitable brown-field site in the Uly-

only hundred kilometres away.

Special Economic Port Zone

In the region there is one site with a special tax and customs regime which has federal status: the Special Economic Port Zone (SEPZ), created on the basis of the international airport "Ulyanovsk-Vostochny". Today, it is the only special zone connected with aviation in Russia. This is a logistics hub and a custom port for foreign manufacturers. It is designed for companies specializing in the repair and maintenance of aircraft, manufacturing of aircraft and aviation components, and logistics services. There are already six occupants, "Volga-Dnepr Technics Ulyanovsk", "FL Technics Ulyanovsk" LLC ("Avia-SolutionsGroup" (Lithuania), "Aircraft Factory Vityaz" LLC, "Interavionika" (OJSC "Aviapribor Holding"), "AAP-Rus" LLC and CJSC "Promtech Ulyanovsk". About 10 more companies are currently preparing projects for implementation.

Construction

The government of Ulyanovsk Region and Ulyanovsk Region Development Corporation provide complete support to the investor in both the pre-construction preparation phases, assistance in preparation and execution of all necessary permits and project

propriate and comfortable environment for doing business and living for the personnel of foreign companies. This includes the availability of kindergartens, schools, quality housing, medical facilities with English-speaking personnel, developed road infrastructure, direct flights to Europe, the presence of an entertainment industry and safety in living and doing business in the region. In the Ulyanovsk region significant attention is paid to this.

In 2010 the park-hotel "Imperial Club Deluxe" was opened, and nearing completion is the international-standard hotel, "Hilton Garden Inn". A "Marriott" hotel is planned, and the concept of an apartment-hotel is being worked out, in which the investor

will be provided with a full range of accommodation services. Likewise, the establishment of an international school with certified educational programmes for children in foreign languages is being considered. In summer 2013, from the international airport "Ulyanovsk-Vostochny", direct flights to Germany will be launched. The airport terminal is also being modernized, and numerous shopping malls meeting international standards are being opened.

So already today we are making our best efforts to make the Ulyanovsk region one in which, within a year or two, it will be comfortable to live and to work.

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Svetlana Ganeyeva

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FAVOURABLE INVESTMENT CLIMATE IS A KEY PRIORITY OF MOSCOW AUTHORITIES

Being an important international financial centre, Moscow has been attracting investors' attention at all times. In 2012 the amount of investment in fixed assets exceeded 1 tln roubles. The growth of fixed-asset investments amounted to 8.5% compared to 2011, which is higher than the average rate for Russia. Private investments represent 70% of the entire amount. Moscow accounts for around 23% of all direct foreign investment in Russia.

High attractiveness of Moscow for investors is determined by its capital status, high income level of its citizens and existence of strong financially reliable demand as well as developed transportation infrastructure ties with other Russian regions. For many years considerable investments have been flowing to Moscow without any special complex measures taken by the Government of Moscow. It is obvious that lately most investments have been made in the high-yield sectors, such as construction of residential buildings, shopping malls, entertainment and business centres. At the same time, the negative influence of new constructions and absence of sufficient infrastructure created huge burden for the city and aggravated the urban environment quality. The costs of infrastructure development were fully borne by the city budget.

Today our primary goal is to create favourable conditions for attraction of private in-

vestments in Moscow, including brand new sectors. Moscow is interested in bringing new technologies, including management techniques, in developing and offering advanced services for Moscow citizens.

Moscow authorities develop a comprehensive set of measures to provide more comfortable conditions to attract new investors. Main priorities for City Government are reduction of cost of doing business, simplification of administrative procedures, expansion of access to infrastructure, development of a competitive environment.

For instance, last year significant changes were introduced in the land property auctions process, which became more transparent. The procedure for participation in land auctions was simplified — now a bidder should submit only three documents during the tender application, auction process information (including characteristics of an object, photographic materials and location plan) is posted on the official website. The procedure of conducting road shows dedicated to all land property that is put up for auction became an integral component of the bid campaign.



Today our primary goal is to create favourable conditions for attraction of private investments in Moscow

The Moscow Government aims to develop long-term mutually beneficial relationship between authorities and business community, which will supply both citizens' and investors' needs. One of the key goals is to attract private investments in sectors which have been traditionally funded from the city budget — public healthcare services, education and transport. One of



Svetlana Ganeyeva

Svetlana graduated from the Moscow Engineering and Physics Institute (1996), earned Master's degree at the Higher School of Economics (1998) and a Master of Law at MGIMO. Beyond a profound knowledge of the investment and legislative processes, Svetlana has more than 15 years of practical experience in promoting the investment and business climate in Russia.

Svetlana has made prominent career at the Russian Ministry of Economic Development and Trade, where she headed key departments. She was among the authors and developers of the legislation for PPP projects in Russia.

Prior to working for the Moscow City Investment Agency, Svetlana was Director for Development at the Russian Centre for Strategic Research, and Director for Development at the Russian office of PwC.

the mechanisms that are implemented in order to achieve this purpose is private-public partnership.

Concession agreements, a form of private-public partnership which is rather new mechanism for Moscow, are now being tried out in the city. For example, in healthcare sector, municipal hospital № 63 is one of the first objects of the concession agreement. It is one of the oldest medical institutions in Moscow. The total planned investment for this project amounts to 4.37 bln roubles, from which on reconstruction it is planned to spend about 2.88 bln roubles and on the technical equipment of the hospital — 1.49 bln roubles. The main criterion of the an-

nounced tender is the mandatory scope of medical services covered by compulsory hospital insurance (from 20% to 30% of total provided medical services).

The application to given competition was filed by one of the leading specialized operators ("European Medical Centre"), which has extensive experience in such high-tech medical services provision projects. Now Moscow Government is preparing a list of other healthcare facilities that are planned to be reconstructed with the help of attracting private investments. As a result, the new medical cluster will be created where municipal hospital № 63 will be a pilot project.

Another important investment sector is pre-school education and child care. Now we are actively encouraging businesses to invest in the construction of day-care centres on favourable terms. The Moscow Government is willing to lease out real property and land plots for a 49-year term for establishment of day-care institutions. It is contemplated that as soon as such day-care centres become fully operable, the annual rent will be reduced to 1 rouble for 1 m² (provided that at least 80% of the total number of children visiting such private centres should be natives of Moscow). Under this investment program, around 30 real property units are to be offered for lease through the tender procedure. As per today, a tender for sale of land lease rights for the construction of a day-care centre in Central Administrative District has been carried out, and another four land plots in various parts of Moscow are to be leased out during this year. Along with given program, last February the Moscow Government passed a resolution to provide municipal subsidies to private investors who entered into service concession arrangements and provide services to citizens on the child care waiting list.

We are adopting life-cycle contract (LCC) mechanisms for transport infrastructure. It is a new approach to the purchase and operation of the subway cars that is being currently tried out. The introduction of this system will reallocate the

burden on the city budget, which is extremely important taking into account the capital intensity of such projects, as well as the growing need of development of the underground transport.

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Another important investment sector is pre-school education and child care

LCC is a new form of public-private partnerships for Russia, but it has already proved its efficiency in other countries, particularly in the transport and infrastructure projects where the costs for repair and maintenance of the facilities are comparable to its value.

Moscow is also actively offering incentives for innovation businesses. During the period of 2012-

2016, the city is going to allocate 8.2 bln roubles from the budget for the creation of technological parks, technopolises, industrial parks, where most favourable conditions will be created for the development of high-tech and knowledge-intensive businesses. For instance, tax incentives have been offered for innovative companies. They enjoy exemption from property tax for 10 years, while the income tax rate for them will be 13.5% compared to standard 18%.

We hope that due to the above mentioned solutions the flow of both Russian and Western investments to the city's economy will increase dramatically.

The success of any project is ultimately determined by the effectiveness of the financial model offered to investors. Our prime objective is to conduct a dialogue with investors, find the ways for mutually beneficial cooperation, and streamline investments.

1 in 10 middle and top managers in Russia expect a minimum salary rise of 50% when they move jobs. Is that what you would expect?

Job Market Overview & Salary Survey 2013-2014

We are pleased to present the fourth edition of our annual "Job market overview and salary survey". This year the survey embraced 5,510 high-level professionals and middle and senior managers. We hope that the data presented in the book will help you and your business better navigate the contemporary trends in the labour market. Please request your free copy at www.antalrussia.com/salary-survey-request-form.

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FACILITATING
ENTREPRENEURSHIP
IN

RUSSIA

PART IV >>

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Chetwynd Bowling



Alex Medlock

SMEs DOING BUSINESS IN RUSSIA: GETTING STARTED

It is well accepted that Small and Medium-sized Enterprises (SMEs) play a major role in most economies, both in terms of the economy itself and also social infrastructure. However, this sector has not received the required investment and resources in Russia. But attitudes in Russia are changing and we see this in terms of increasing pronouncements of support from top politicians and government officials. As an example the state owned bank, Vnesheconom Bank, has a subsidiary dedicated to financing SMEs—“SME Bank” at <http://www.mspbank.ru/>. The AEB SME committee invited the SME Bank to make a presentation at its open event held on 4 December 2012.

As a way of introduction to what we feel are some of the most important issues to consider by SMEs investing in Russia, we would point out that the general lack of attention and support for SMEs means that owners or managers of smaller operations are often shocked by the cost of entry into the market, both in time and money. One low-cost market entry strategy is to use a Professional Employee Service whereby a local service firm hires your Country Manager or Sales Rep onto their books, saving you the time and cost of setting up shop. This Employee without Establishment model is not without its risks, and one should also consider the relevant tax aspects. Local service providers are now offering package solutions tailored for SME start-ups.

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Below, based on our more than 15 years of experience in the outsourcing market, we highlight some of the issues that we consider important.

SETTING UP A LEGAL PRESENCE: LIMITED LIABILITY COMPANY (LLC); JOINT STOCK COMPANY (JSC); REP OFFICE; BRANCH

Limited Liability Company (LLC)

The easiest way to go is to set up an LLC, or OOO as it is known in Russia. Russian law allows for a single shareholder and a single executive, the General Director. Both corporate and individual shareholders are allowed. In order to complete the registration process it is necessary to have a General Director, and this brings us to often one of the first challenges as the company may not have identified: someone to fill the role. As an interim

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solution, until a suitable candidate is found, it may be desirable to outsource this function to a reputable third party. Also, at the incorporation stage, it will be necessary to specify a registered address and again, as an interim measure, an out-sourcing specialist can provide a solution until premises have been found.

For a corporate shareholder, the process is more complicated as 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. Another option is for the CEO to come to Russia to complete the process. If this is not possible, then a nominee shareholder (this would be the local manager, if he is trusted or one provided by the legal firm handling the registration) is appointed and he will sign all the application documents.

Comparison of Structure and Finance Aspects: JSC vs. LLC

Joint Stock Company (JSC)

While the process is similar, there are some differences in the incorporation process of a JSC, known as ZAO by its Russian acronym (see table of comparison below). For example, it has the additional requirement of having its shares registered by the securities commission at incorporation. This legal form is most suitable 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.

The “accreditation” process as it is called in Russia can take much longer for a Rep/Branch office compared to a LLC or JSC. The whole process can take 6 to 8 weeks but there is the possibility to opt for a “fast track” process.

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.

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 to consider: share capital, loans, parent-subsidiary financing, or cost + arrangements.

The statutory share capital for a Russian legal entity is rather small (approx. 220 Euros). This type of funding is not very attractive, as your funds are stuck in Russian roubles with all the related currency risk.

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 investors 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 members' 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.
50% of charter capital must be paid within 3 months of registration and 50% within 1 year. Minimum capital required is 10,000 rub.	50% of charter capital must be paid before registration and 50% within 1 year. Minimum capital required is 10,000 rub.

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

RLE	Branch/Rep Office (B/R O)
Legal A separate legal entity that bears its own liabilities.	Liability is borne by the Head Office or Parent company.
Accounting Compliance and Tax Filing 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.	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) is made. Rep Offices which do not carry out commercial activities are exempt from VAT on their rent payments.

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 of cash in the subsidiary. 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.

Cost+ arrangements are becoming more popular as a means of financing a local subsidiary, which is not trading locally. 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.”

FINDING A MANAGER — LOCAL OR EXPAT?

Should you hire a local (Russian) manager, with a clear understanding of the local culture and business ethics? 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 an SME, you will be competing with the big firms and be expected to pay top dollar to good managers.

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 start-ups before, and 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 2-3 years, with relatively low pay to gain this experience.

HR ISSUES IN RUSSIA

Twenty years ago staffing was not a problem, instead the issue was a shortage of skills. Now we almost have the reverse situation where in today's market there is generally not a problem with skills but there is an issue in finding available staff.

It is generally accepted that Russia has a very well-educated work force and that many young people are innovative. One

growth are growing in significance. With regard to additional employee benefits, private medical insurance has become the norm, even for SMEs.

One peculiarity about compensation in Russia is that all employees think "nett salary". Therefore if a potential candidate says he is looking for 100 roubles in salary, then that is 100 roubles in his pocket, with the tax grossed up and paid by the employer.

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 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 RUB 60 mil-

d) Personal Income Tax. This is the employee's personal obligation; tax rate is a flat 13% for residents and 30% for non-residents.

e) Social insurance payments. This is the employer's only obligation; the tax rate is 30% for 2012. There is also an additional 10% for employees that earn over a certain threshold.

CLOSING DOWN YOUR BUSINESS IN RUSSIA

Before investing in setting up a legal presence, be aware that closing down a legal entity or rep office can take from 6 to 12 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 quite bureaucratic and records may not be easily accessible due to technical difficulties.

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, using a Professional Employer Service, 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.



Before investing in setting up a legal presence, be aware that closing down a legal entity or rep office can take from 6 to 12 months and can be quite expensive

successful owner told us recently that in his view "Russia is a laboratory of ideas." We therefore find that many SMEs succeed in attracting good people by offering a good working environment, consensual decision making, attention to training and development, and maybe some form of ownership participation. What we have also been told by successful owners of SMEs is not to underestimate the importance of treating people well, being appreciative and having a good working environment. Also, be open with people and let them know what is happening and treat them with the respect that they deserve. With regard to talent retention and motivation, salary is still the biggest factor. However, job satisfaction and career

lion (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. General tax rate is 18%; for certain groups of goods 10%; export operations 0%.
- b) Corporate Profit Tax. Tax rate is 20%.
- c) Property tax. Tax rate depends on the region of Russia, but cannot exceed 2.2%.

INDUSTRY
SPECIFIC
ASPECTS
OF INVESTING
IN
RUSSIA
PART V >>

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ANTIMONOPOLY LEGISLATION

On 28 December 2012, the Russian government adopted a "Road Map" document, On Developing and Improving Antimonopoly Policy, which aims to increase competition in Russian business. This Road Map sets ambitious goals and stipulates a list of specific steps to be taken from 2013 to 2015, in specific industries such as pharmaceutical and medical services, air transportation, telecoms, oil products, etc. Implementation will result in improvements to people's lives in Russia in the short term.

Some of the steps stipulated in the Road Map are already being implemented. On 12 March 2013, the Russian parliament adopted at the first reading draft amendments to Federal Law No. 135-FZ dated 26 July 2006 On the Protection of Competition (the "Competition Law"), which abolish in most cases the requirement for post-completion notifications in case of economic concentration (M&A transactions, reorganization, acquisition of

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tions in 14 cases. At the same time post-completion notification requires almost the same volume of input as a pre-completion applica-

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Cartels have recently become a hot topic for the FAS. Although the Competition Law has always prohibited such agreements, the notion of a cartel was only introduced into the Competition Law in late 2011 together with other rules aimed at increasing liability for these offences. The year 2012 was the first year that FAS had applied the new provisions on cartels. The turnover fines for such types of administrative offence totalled RUB 2.86 billion (approximately EUR 71.5 million). Operating a cartel is a crime and the management of companies involved in cartels can be sent to jail for up to seven years. To date, however, the legislation has only resulted in a small number of prosecutions. Recently the Russian government adopted draft amendments to the Russian Criminal Code that would exempt the management of a company which was the first to denounce the cartel from criminal liability. Although such companies are currently exempt from administrative fines, this exemption had not applied to the criminal liability of their management. Now the Russian government will submit these draft amendments



The Road Map sets ambitious goals and stipulates a list of specific steps in specific industries such as pharmaceutical and medical services, air transportation, telecoms, oil products, etc.

assets, etc.). As indicated in the explanatory note to the draft amendments, such controls over economic concentration are not very effective. In 2011 the Federal Antimonopoly Service (the "FAS") reviewed 2,124 post-completion notifications, but only issued instruc-

tion, resulting in virtually the same time costs and expenses for an applicant. Once the requirement for post-completion notifications is abolished, the FAS will focus primarily on reviewing pre-completion applications, as well as on identifying and breaking up cartels.

to the Russian parliament for consideration. The FAS hopes that as a result of this provision managers will become more proactive

decides not to travel, with the establishment of the procedure and terms for a refund, and also the steps to be taken if an airline refuses

liberalizing inter-governmental agreements on air travel, which lift restrictions on the number of airlines, established routes, the frequency of flights and tariffs, will be implemented. All this should result in an increase in competition in this sector and allow low-cost airlines to operate in Russia.



There are plans under the Road Map to eliminate instances where IP rights are used to abuse or restrict competition. This would mean, for example, the liberalization of parallel imports

in denouncing cartels and providing information about them to the competition authorities. This exemption from liability is also contained in the Road Map. The FAS also plans to work more closely on cartels with its foreign counterparts and international institutions and organizations.

to return the money paid by a passenger if he/she decides not to travel. Also foreign pilots will be allowed to fly the aircraft of Russian airlines, and airlines will have the option not to include in the tariff charges for on-board meals and drinks. The allowances for free luggage have been revised and the

Foreign Investments in strategic sectors of the Russian economy

On 9 April 2013 the Russian government approved FAS proposals to liberalize certain aspects of legislation concerning foreign investments in strategic sectors ("the Law"). As expected, the Duma has approved these amendments at the first reading during the May 2013 session.

It is a clearly stated political aim to remove administrative barriers to foreign investment in the Russian economy. Accordingly,

Subsequently there are plans under the Road Map to eliminate instances where IP rights are used to abuse or restrict competition. This would mean, for example, the liberalization of parallel imports. The FAS believes that such a measure would result in greater competition and lower prices. The Road Map also stipulates the issuance of FAS clarifications with regard to certain matters, including vertical agreements (dealer agreements). Consumer protection measures include the drafting a law on consumer class actions and also the imposition of multiple fines for violations of competition rules.

In the pharmaceutical sector there are plans to introduce the concept of "interchangeable pharmaceutical drugs", compiling a list of them and introducing a requirement for prescribing pharmaceutical drugs on prescription forms based on their international non-proprietary names. As a result the prices of pharmaceutical drugs should fall.

Steps to increase competition in air transportation include improvements to the procedure for recovering the air fare if a passenger

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the draft bill removes the obligation for foreign investors to receive prior approval from the Commission on Control of Foreign Investments for deals involving federal subsoil deposits if the Russian Federation owns directly or indirectly more than 50% of the voting shares in these deposits and retains such control over these sites after the intended transaction.

In cases where the foreign investor already owns, prior to the intended transaction, 75% of the voting shares in a Russian strategic company (federal subsoil deposits are excluded from this exemption), the investor no longer needs to receive approval for the purchase of additional shares.

Another long-awaited amendment concerns the relaxation of rules on investing in Russian food enterprises. Until now they had to a significant extent been categorized as strategic activities, including breweries, dairy plants and some juice producers. After the adoption of these amendments, prior approval from the government Commission will no longer be required.

With regard to the reduction in technical and administrative barriers, foreign investors will now be allowed to apply for an extension of the duration of preliminary deal approvals that they received from the Commission on Foreign Investments if they did not manage to close the deal during the period of the approval term. Previously, it had been necessary to formally apply again, providing the whole set of documents required to receive such new approval.

In a nutshell, the proposed amendments are certainly necessary and a right step towards liberalization of the foreign investment regime. However, the removal of excessive and unintended consequences regarding the application of the Law does not make this legislation per se more liberal, but shows instead that the initial concept and wording of the Law was too protective and tended to complicate the inflow of foreign direct investments. It goes without saying that interests

of strategic national importance must be protected and that deals of such significance must be controlled by the government. However, compared to other European jurisdictions, it would appear possible to achieve this aim with far less bureaucracy and fewer administrative barriers.

One of the major concerns of foreign investors is that it is often the case that the established deadlines in the Law for the adoption of decisions by the government Commission are not met. The Law explicitly states that the Commission should take a decision not later than three, and in exceptional cases not later than six, months after the receipt of the application from the foreign investor. Practice shows that the review process frequently takes longer and that this has a material adverse impact on the investment climate. It is a major prerequisite in M&A deals that the time-line until closing can be calculated. This



One of the major concerns of foreign investors is that the established deadlines in the Law for the adoption of decisions by the government Commission are not met

calculation regularly includes the time required for regulatory approvals. If a foreign investor cannot reliably expect a decision on an application for the approval of a transaction within the maximum six months as stipulated by the Law, the economic rationale of the whole deal may well be questionable.

The Law also stipulates that a foreign investor may undergo the clearance process with the FAS within 30 days in cases where the investor has doubts as to whether the acquisition of a certain stake in a strategic enterprise would result in "control" over this enterprise.

The FAS is in such cases obliged to inform the applicant within 30 days whether the intended transaction requires approval from the government Commission or not.

One would think that the transaction in question would not need regulatory approval after receipt of notice from the FAS and that the respective transaction documentation could be signed. However, the FAS needs to inform the government Commission of such a decision and the Commission can still veto any such decision taken by FAS. Accordingly, the document received after 30 days from the FAS has no legal status until the government Commission takes notice and declines to challenge such a decision. The AEB Legal Committee repeatedly raised this issue during a recent meeting with the Head of the FAS, Mr. I.Y. Artemiev, and was assured that the issue would be resolved and that the responses of the FAS in this regard would be conclusive in future.

Another matter of concern is that the FAS and the government Commission do not explain the reasons for their decisions. It could be argued that reasons might not be provided in cases of strategic importance. At the same time, however, how can an investor exercise its right to challenge decisions in court if no reasons for them have been provided?

In order to stimulate foreign investments and, at the same, protect national interests, it is necessary to adhere to established deadlines, provide transparent explanations and maintain open dialog with the business community. Regarding the latter, we can clearly state that such a dialogue between the FAS and the AEB is very open and productive, and that the FAS is always willing to hear proposals from the European business community on how to improve the investment climate for foreign companies. Such open-mindedness is welcomed by European investors and greatly appreciated. At the same time, however, a lot of work still needs to be done. It is in the joint interests of both Russia and foreign investors to continue this work together by accepting and understanding the needs of both sides.

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Dmitry Litovtsev

VENTURE CAPITAL IN RUSSIA: OVERVIEW AND OPPORTUNITIES FOR START-UP FINANCING

Leading countries today are prioritising the development of new technological frontiers. Sustainable economic growth is impossible without moving from a resource-based economy to innovation-based intellectual resources, high-tech and information technology, and efficient use of all factors of production. The economy needs an economic and financial architecture that will minimize the impact of global economic disasters, as well as ensure quick and timely financial support for breakthrough ideas of local entrepreneurs.

Venture capital, as a necessary and important element of this architecture, can have a direct impact on the foundations of economic activity in all areas of the economy, thereby helping economic growth, and the formation of a technologically advanced, modern, diversified economy.

Against the background of the course of innovation, the venture capital industry in Russia has a special status as the modernization engine and implementation tool of both political and economic plans. Ignored a decade ago, the industry is now being actively developed under the leadership of development institutions like Rusnano and the Russian Venture Company. It is also timidly entering the Russian market for in-

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At various times, he has worked as Deputy Head of Financial Institutions at OJSC Nomos-Bank; Vice President of International Business at FC Uralsib; Director of International Projects at JSC Finam' and Managing Director of Capital Markets at IFC Metropol.

He has been with IC Russ-Invest since 2011.

ternational investors. Small venture funds, declaring their readiness to invest in high-risk innovative projects have appeared in Russia with amazing speed. Most significant financial and investment groups have units which are responsible for finding and selecting such investments.

Having insufficient experience, and with an almost complete absence of the necessary infrastructure, whether technical and financial or legal, Russian financiers and entrepreneurs have been trying for several years to create something that evolved in the United States over many decades. In Russia, we are in the development stage, which took place in the U.S. in the '90s of the last century. Arthur Baganov, President of the international investment and consulting company Baganov International Group, and previously Managing Director of seed funding at Microsoft, has written, "Bankers, stock brokers, managers, agents for property management, economists, experts in IT-sphere and even former politicians or their children who

He graduated from the Faculty of Engineering Business and Management of Bauman Moscow State Technical University in 2006. At various times, he has worked as Investment Analyst at Private Equity fund, Alltech Investments; Investment Project Manager at OJSC Energostroyinvest Holding; and Deputy General Director at Financial House, Solid. He has been with IC Russ-Invest since 2012.

graduate from prestigious western universities, seeking to become venture capitalists, or as it is now fashionable to say in Russia, venture partners."

Industry analysis indicates that we are currently witnessing a turning point in the development of venture capital, in particular seed investments, as a tool for the development of young companies. Can we build an economy of innovation and technology, as has happened in the U.S., Israel, Finland, part of France, Germany and India? Or will we take the path of Canada, Australia and Japan, where the tendency is for large industrial corporations to operate their own research and development departments, creating venture companies within their own organisations, for their own needs?

The venture capital market in Russia is developing according to the European model. In this regard, it is difficult to separate the field of direct investments (private equity) in already well-established companies, which are under planned development, from direct venture capital (venture capital) which is used for financing new ventures and young companies.

Many funds that make direct investments are composed of separate units or separate legal entities, with responsibility for finding and funding new projects and start-up companies or companies at the seed stage of development. Even funds that specialize exclusively

In general, investors other than those with strategic targets, are portfolio investors who buy a range of assets, balanced in terms of risk and potential return. This type of investor is interested in increasing the value of their investment and subsequently exiting

Market experts say that the presence on the market of seed investments creates a special breed of people who are earning money first from their own intellectual products, but who intend to move on. The first operation may not be the most high-tech, but the important thing is that there is an expansion of the innovative and entrepreneurial environment. Some of these projects remain small, while others go to the next stage of financing and attract private equity.



In general, investors other than those with strategic targets, are portfolio investors who buy a range of assets, balanced in terms of risk and potential return

in large transactions involving mature investment objects, often so-called second-stage investors, picking up the baton from “pure” venture capital funds by buying their shares in successful projects, represent an important part of the venture capital market.

The Russian venture capital industry can be said to have begun in 1993, when in Tokyo, as part of a G7 meeting, it was decided to allocate funds for Russian investments into venture projects financed by the European Bank for Reconstruction and Development (EBRD). The Bank was to provide \$500 million in total, establishing 11 funds, the first in 1994, and the last in 1996. In retrospect, we can say that these were not venture capital funds, but private equity funds, focusing on medium-sized companies, already in the growth phase.

by selling out to other portfolio investors. Strategic investors often exit by means of an IPO in which they sell to a wide range of persons, or to the management team of the company involved. Portfolio investors often prefer non-controlling stakes (less than 50% of the voting shares of the company). But in Russian practice, there are those who insist on controlling the activities of the recipient of the investment. For the portfolio investor it is important to understand the terms of the investment, and to have a clear exit plan.

Investors at the seed stage business angels, seed funds and initial venture capital investment. Seed investments have great infrastructure value and a great educational role.

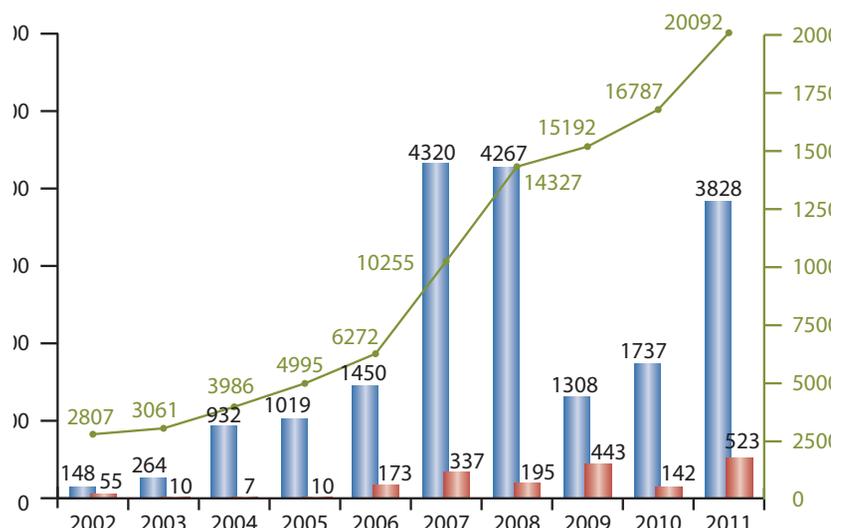
The amount of venture capital funding currently available in Russia is difficult to determine. This is due to the inadequacy of the overall information industry, the inactive or semi-active style of many of the funds, as well as the fact that a number of organisations have failed to attract sufficient capital to start a full-fledged business. It is believed that, as of 2012, the number of venture capital funds in Russia was between 150 and 200, with the active ones numbering perhaps 50.

Recent years have seen the continued creation of funds that have a distinct specialization. In particular, in 2011 the first investments were made by the first Russian “mezzanine” fund. Now there are about a dozen such funds. With public support, formation of the largest infrastructure fund

The main types of investors in the Russian market for private equity and venture capital are:

- Business angels
- Seed Funds
- Foundations initial venture capital investment
- Foundations late venture investments
- Private equity
- Strategic investors (focused on the uptake of business)
- Pre-IPO and mezzanine funds
- Funds investing in organized capital markets.

Venture funds' dynamics in Russia



(RFPI) investments will, no doubt, have a significant near-term impact on the entire landscape of the established Russian private equity industry. Also the biotechnology and infrastructure funds of JSC RVC have been formed with the help of Rusnano nanotech funds, funds deployed in the pharmaceutical industry, in the field of “clean” technologies, etc.

In 2012, the accumulated capitalization of funds operating in Russia reached about \$23 billion, or about 15% more than in 2011 (\$20 billion). However, the rate of growth is way below pre-crisis levels. In 2008, the increase

total number of funds with the participation of Rusnano will be nearly 15.

Given the available information, it can be stated that in 2012, the accumulated growth of the Russian market capitalization of nearly \$ 2.7 billion was provided by about 20 private equity and venture capital investments. Except for a few funds that have implemented interim closing, the newly-raised capital in 2012 is associated with the formation of new funds. It is noteworthy that venture capital funds provides about one-sixth of the capital gain made on about two-thirds of all new funds.

and take money from friends and family, to make the first design, then sell it or attract the next round of investment and move on to the next stage of business development. The best results from seed investments have been seen in the IT industry, with the emergence of Facebook, Twitter, LinkedIn, Google and YouTube. The same approach can be applied in other industries.

If we talk about venture investments overall, foreign ecosystems differ from the Russian one, especially by size and maturity. In the USA, central and western Europe there are substantially more funds, more accumulated experience and project management methods.

In Russia, according to industry players, a comparable level of understanding has not been achieved yet. However, it is felt that the Russian market will catch up with its western exemplars. We see a positive trend in relation to innovation. People have begun to take it more seriously. And we meet classic success stories, when the development team received a grant, created a model, then found a local investor, produced a series, and now has a strategic partner or a major direct investor to expand production. We have such examples across the country.



We meet classic success stories, when the development team received a grant, created a model, then found a local investor, produced a series, and now has a strategic partner or a major direct investor to expand production

of capital value was about 40% compared with 2007, and in 2007, about 60% compared to 2006.

On the Russian market, the volume of new funds in 2012 amounted about \$2.7 billion, whereas in 2011 it was about \$3.8 billion, which was 2.2 times more than in 2010, which was \$1.74 billion.

Management companies plan to raise new funds, on top of the current level of more than \$15 billion. An analysis of the fund-raising process shows that the intention to raise money for new funds is often implemented on schedule. We should stress that the market potential for raising capital in the short term is very high. In particular, a significant contribution to the formation of capital funds in Russia continues to come from JSC Rusnano—it is expected that the

In general, the growth of capitalization of accumulated funds can be described as positive. A number of operating companies in 2012 are actively working to raise newly formed funds, and it is expected that this trend will continue in 2013.

Russian seed investments are not fundamentally different from the Western model, even though the country lags far behind in the size and stage of development. The cardinal rule is that business should make money and make capital gains. However, given the high degree of risk at the seed stage, the investor should be able to expect a higher return on investment. Throughout the world, the so-called “rule of the three Fs” applies to sources of seed fund investment: Family, Friends, Fools. There is no substantial reason why this rule should not operate in Russia. People use their savings,

Josep Rodo Cima
Executive Commercial Director,
Gestamp Severstal Kaluga

INVESTING IN THE RUSSIAN AUTOMOTIVE INDUSTRY

Gestamp Automocion an international group dedicated to the design, development and manufacture of metal components and structural systems for the automotive industry. Today, Gestamp Automocion operates in 22 countries and has 95 production and 13 R&D centres, and over 25,000 employees. Gestamp Automocion currently has 3 plants in Russia: Gestamp Severstal Vsevolozhsk, Gestamp Severstal Kaluga and Gestamp Togliatti, employing over 500, and with an investment of 310 million Euros.

When we talk about the automotive industry in Russia, we are talking about the fastest-growing industry in Europe in the last 12 years. This rapid growth has created an interesting situation; the automotive industry in Russia could be defined as a young one, operating in a semi-archaic legal environment,

terms of localization, the distances between clusters, the decrees of the government regarding customs clearance and the lack of local auxiliary industry to support OEMs and component suppliers all contribute to this particular environment.

The aim of this article is, after analysing the current situation of the market, to describe the pros and the cons of investing here as we see them. I give three pros and three cons:

Reasons to invest in automotive in Russia:

- Growth of the industry within the overall economy of the country. It is no secret that Russia, as a BRIC, is one the most attractive countries to invest in due to its internal growth. Many products have to be manufactured in the country to meet existing demand. The automotive industry has the highest rate of demand growth in the country. For example, in 2012 more than 2.7 million cars were sold, and the forecast for 2013 is 3 million. This is the strongest point when we speak about reasons to invest. PwC's last estimates forecast continual growth till 2025.
- Long-term strategy and possibilities. Many OEMs are strategically locating to Russia, on the basis of a long-term strategy in Russia. For many of the larger companies, the aim is to produce cars in Russia not only for the internal market but also possibly



When we talk about the automotive industry in Russia, we are talking about the fastest-growing industry in Europe in the last 12 years

but with mature players. Moreover after some years operating in Russia, OEMs and component manufacturers are already facing troubles which, in other countries, were encountered only after several decades of manufacturing. The peculiarities of Russia in

for export to Europe. Indeed some car and components producers are already doing this, and more are doing so every year. Being in Russia has other advantages: the raw materials needed are here, and conditions for manufacturing are currently quite attractive.



Josep Rodo Cima

Josep Rodo Cima holds a Master in Business Administration degree from Grenoble Business School. He came to Russia as a top manager in 1999 and has been working in the automotive industry here since 2007. Mr. Rodo has been the General Manager of the biggest stamping facility of Gestamp worldwide (Gestamp Severstal Kaluga) for the last four years. From April 2013, Mr. Rodo has been the Executive Commercial Director of Gestamp in Russia. He speaks Spanish, Russian, English and German.

- Synergies with Europe and opportunities for new products. As a consequence of the second point, lots of synergies can be created with Europe. Russia is a country where our technologies can be developed with our know-how. We cannot come to Russia to try new things. Every company has to do in Russia what they do well in Europe. But in Russia, due to the lack of suppliers and local auxiliary industry, we can be asked by a client to introduce a product related to our business that may present a good opportunity to diversify our portfolio. Usually our company produces this product in Europe in another facility, so synergies with this European facility can be created in order to take the opportunity to develop this product once the client requests it in Russia. Our experience is that this happens quite often.

Reasons against investing:

- Legal environment. The legal environment in Russia is one of the problems that all foreign corporations face when they invest in the country. This issue takes on a greater sig-

nificance if the foreign company comes alone or with a Russian partner. Questions like the percentage shares of the Russian subsidiary in both sites, or which kind of company—“OOO”, “ZAO” or “OAO”—and many others can be contentious in the event of litigation. Many corporations in the automotive industry, as global enterprises, have a lot of experience investing overseas. But the Russian legal environment is highly ambiguous, and those issues mean the processes that might take some weeks in another country become protracted here, especially when a local partner is involved. That is why it is very important that the corporation wanting to invest in the country should evaluate all possible options and scenarios regarding the juridical structure of the company before taking a decision. The system is so rigid and complex that subsequent changes are rarely an option.

- Customs clearance. Russia, as a member of the WTO from July 2012, has made a lot of changes towards opening up its system, but

ply, the costs may increase your component prices by as much as 20%.

- Be ready to pay VAT in advance. The customs will also request in advance the cost of the VAT on the equipment or components you are importing. If the case is:
 - Import-export: you can have the VAT retained for years before getting it back from the customs.
 - Contribution in kind: you did not pay tax as this is an investment in equipment, but VAT should be paid in advance, which also can take more than a year to get back.

Comment: Some banks in Russia provide letters of credit for such operations, but the amounts are not large and the interest rate can be high.

- Bureaucracy is definitely a big issue. Sometimes customs can request extra documents from the importer, and sometimes these can be difficult to get. Meanwhile your

does, so be careful when you fix a price in roubles if some finished parts of a vehicle have components priced in Euros. This issue is very sensitive for OEMs.

I have tried to give an overview of the market on the basis of our experience in the automotive industry in Russia. Different companies have different needs and maybe these three pros and cons do not apply to everyone. But due to our kind of operation at Gestamp in Russia these are the main factors that could help you when you come to deciding whether or not to invest here.

Our experience is positive, but we want to take this opportunity to encourage the Russian administration to continue improving those points that are still critical in our view in order to create the proper atmosphere in the industry that will help investors achieve their goals.

OEMs also face other problems. The quantity of vehicles to be produced, and the percent of localization are very challenging goals for them. Also high interest rates for consumers—close to 15% in some cases—makes car purchases too expensive for many consumers.

This view is based on our experience over the last five years. It is worth repeating that these are the pros and cons that Gestamp found in Russia. Another company or another type of car component firm might see things differently. However, I have tried to be as clear as possible in sharing with all of you the challenges and advantages we have faced when investing in the automotive industry in Russia.



It is no secret that Russia, as a BRIC, is one the most attractive countries to invest in due to its internal growth

still customs are one of the problem areas when we talk about investment.

Likely problems are:

- Multiple options for clearance of the same product. Companies generally try to clear using the cheapest option (nomenclature). This can be risky as the customs post could declare it invalid and then it takes an enormous amount of work and time to remake it.
- Cost of the customs. If you are under the Decree 166 or 566, you are able to clear goods (components) without paying tax. But be careful to ensure that all documents are completed. Every year, all companies operating under this Decree are audited by the customs. Also be aware about the performance of localization. If that does not ap-

ply, the goods will be held by the customs, paying storage charges per day.

- Holidays: in December and May customs are overloaded due to the number of days off and the quantity of goods coming in. Your transport can be stopped for weeks while waiting to be cleared.

Comment: the best option is to have a good customs agent who will advise you in every case how to proceed.

- Economic dependency on oil. This is one of the biggest stability factors in the Russian economy and at the same time the biggest threat that any investor can face. The rouble is directly affected by the fluctuation of the oil price. If oil goes down, the currency also

Sergey Patrakeev
Counsel, Lidings

REGULATORY INITIATIVES IN THE PHARMACEUTICAL AND HEALTHCARE SECTOR: NEW RULES FOR MARKET ENTRY?

The Russian pharmaceuticals market has been on a constant upward trend in recent years, but still has considerable potential for further growth. The development tempo in future will depend *inter alia* on the ability of regulating authorities to set up clear and transparent rules for the market players. The problem is especially acute in the context of the innovative path proposed by the government for the industry's development (see the Federal Program "Pharma 2020" approved by the Russian Government Regulation of 17 February 2011 No. 91).

Aiming to keep pharmaceutical regulations up to date, the competent public authorities have proposed recently a series of new initiatives supplementing or amending the provisions of two basic statutory acts: the Federal Law of 12 April 2010 No. 61-FZ "On Circulation of Drugs" (the "Law 61-FZ") and the Federal Law of 21 November 2011 No. 323-FZ "On Foundations of the Citizens' Healthcare in the Russian Federation" (the "Law 323-FZ"). Both of these statutory acts are quite new, so the proposal to amend them is justified not by the intent to reform certain established procedures and practices, but rather by the aim of creating the necessary normative infrastructure for their due fulfilment, and also to fix some shortcomings revealed in practice during their early application.

In this article we would like to review the most illustrative examples of such new initiatives, which will definitely influence the decisions of market players and regulators in the pharmaceuticals sector in 2013.

Transition to GMP Standards

The transition of pharmaceutical manufacturing sites to the standards of Good Manufacturing Practice (GMP) has been mandated in the Law 61-FZ as a prerequisite for maintenance of manufacturing licenses after 1 January 2014. However, it is still not clear which document should determine the GMP standards in Russia. Only recently has it been announced that passing the relevant normative framework for the GMP standards lies within the competence of the Ministry of Industry and Trade. The relevant authorization was issued by the Russian government on 30 January 2013. In spring 2013 the draft standards have been presented to the public by the Ministry of Industry and Trade. It is worth mentioning that several attempts were made earlier to implement international GMP standards in Russia (the most recent one is a voluntary Russian standard GOST R 52249-2009, a verbatim translation of the 2009 EU Guide to GMP). The current draft standards look rather similar to the updated EU Guide to GMP, however no formal reference has been made in the text on this point; so that it is well possible that the wording of draft standards may undergo some "optimizations" yielding in favour of Russian particularities unlike international standards.

This uncertainty unsettles the market since only some 50 enterprises out of about 350 in Russia are reportedly ready to meet the international GMP requirements in some way. The Federal Program "Pharma 2020" reserves RUB 36 billion for financing the transit of a maximum of 75 manufacturing sites to GMP standards, which implies, in turn, a lengthy transition period for such sites, taking several years. In other words, enforcement of the GMP standards in Russia in the near future



Sergey Patrakeev

Sergey Patrakeev is a Counsel in Lidings' Corporate and M&A practice and Co-Head of Pharmaceutical Industry practice in the firm's Moscow office. Sergey specializes in advising foreign businesses on all aspects of corporate law, supports M&A transactions, and acts as a legal expert in deals connected with the purchase and construction of real estate in Russia. He has extensive experience in providing legal support to pharmaceutical companies represented in Russia, such as Meda Pharmaceuticals, Sanofi Aventis, Ipsen Pharma, Ferring Pharmaceuticals, Ever Neuro Pharma and Boehringer Ingelheim. Sergey is described as "very knowledgeable in matters relating to the pharmaceuticals industry" by the prominent professional directory The Legal 500 EMEA.

will have to result, apparently, in closing a number of pharmaceutical plants because they do not meet the GMP requirements.

An appropriate solution in the current situation might be to postpone the introduction of GMP standards, or to provide for a certain transition period by amendment of the statutory norm in the Law 61-FZ. However, the regulating authorities and legislators remain silent on this issue.

"Made in Russia" Criteria for Drugs

One other direction prioritised by the Russian government in the pharmaceutical sector is the localization of drugs manufacturing. A large proportion of the drugs sold in Russia, especially in the middle and upper

segments, is imported. The government's interest is to ensure that the greatest possible added value in the finished product (drug) is attributable to domestic production. Pursuing this aim, not only incentive initiatives are proposed—e.g. creation of pharmaceutical clusters—but also purely administrative instruments like the recent draft Order which the Ministry of Industry and Trade published on its official web page in spring 2013. This stipulates that in order to be qualified as the Russian-made, the finished drug should have at least one component totally manufactured within Russia: either the active substance, or the pharmaceutical form (composition), or the packaging. Importantly, the packaging criterion will be limited by the deadline 31 December 2013.

Registration Requirements

In early 2013, a set of amendments to the Law 61-FZ was proposed by the Healthcare Ministry. The most controversial issue became the notion and criteria for “interchangeability”, since the amendments regarded “interchangeability” as the triggering point for the “speedy” option for registration procedure in relation to generics and biosimilars.

Designating a drug as interchangeable is relevant in a competition between several drugs having the same International Non-proprietary Name (the “INN”), the same active substance, the same pharmaceutical form, etc., in other words when any of them could equally be administered by an impartial physician for treatment of the same disease. A typical situation in this context is the co-existence in the market of one original drug and one or several generic drugs. Generics appear on the market only after expiration of the original drug's exclusivity. To be admitted to the market, each generic should successfully pass the state registration procedure.

The current version of the Law 61-FZ provides that producers of a large proportion

of generic drugs, primarily in form of tablets, suspensions, etc., may choose a simplified path for such registration procedure, i.e. it is sufficient for them to demonstrate biological equivalence to the original drug in lieu of lengthy and expensive clinical trials. The proposed amendments to the Law 61-FZ however close this simplified path. Instead, the new principle of “speedy” registration for the first generic drug in line is suggested. This option is apparently based on US experience. However, in the US the practice of challenging the original drug's patents is established, so that national legislation provides a speedy option for state registration as an incentive for the first generic drug manufacturer who succeeds in challenging the original drug patent. In the bill amending the Law 61-FZ the relevant incentive for the “first in line” generic drug manufacturer is not balanced by the patent-challenging prerequisite. The bill contains no other reasonable justification for such preferential treatment.

One other point of fierce controversy in context of the Bill amending the Law 61-FZ is

may be determined on the basis of certain criteria. Currently the bill amending the Law 61-FZ inclines to the first view, and proposes normative regulation which basically excludes the possibility of registering two interchangeable biological drugs (unless they are identical).

In May 2013, the relevant Bill amending the Law 61-FZ has been submitted for approval within government, prior to introduction before the State Duma. Since many critical comments have been expressed on the Bill's provisions in the course of recent public discussions, there is a reason to believe that the final wording approved by the government will contain revisions mitigating some controversial issues.

One other bill promulgated by the Ministry of Economic Development was presented recently for the public discussions but received less attention. The bill pertains to the state registration of medical devices. The notion of a “medical device” is defined by the Law 323-FZ and covers generally all devices and equipment for medical purposes,



The development tempo in future will depend inter alia on the ability of regulating authorities to set up clear and transparent rules for the market players

the distinction of biological drugs as a separate group. Recently, general understanding has been achieved by national authorities in many jurisdictions that biological drugs require specific normative regulation. The issue of the interchangeability of biological drugs proved to be the key point in attempts to formulate regulatory acts. There are currently two opposing opinions on this issue: the first is that biological drugs may under no circumstances be interchangeable, whereas the other view holds that the interchangeability of biological drugs

and even certain software items. Now, the bill provides for mandatory registration of medical devices, in a similar way to the registration of drugs. This implies inter alia that all goods qualifying as “medical devices” will have to pass multi-tier clinical trials before entering the market. Also, the manufacturing of medical devices is to be subject to supervision, although in a softer form compared with the making of drugs (thus, drugs manufacturers have to obtain specific licenses, whereas mandatory membership in a self-regulating organization is proposed

for medical device manufacturers). Thus, we observe an endeavour to subject the manufacturing and circulation of medical devices to certain uniform rules. However it is questionable whether the regulating mechanisms applicable to drugs will demonstrate the same efficiency in relation to medical devices.

Drugs Marketing

In Russia, the relationship between representatives of pharmaceutical companies (the "PharmReps") and physicians remained for years beyond the regulatory control and normative restriction. This led to situations in which physicians were often under the influence of PharmReps, and hence biased in administering particular drugs to their patients. The Law 323-FZ took the first decisive step in the direction of restricting direct contact between the PharmReps and physicians. The relevant provision introduced a general prohibition on direct contact. It has been construed however as affecting physicians only, and it does not have any direct effect on the PharmReps. So violations of the direct contact ban become the physician's liability, whereas the PharmReps (who are actually more interested in establishing the direct contacts) bear no negative legal consequences.

In order to bring the allocation of liabilities into balance, the Healthcare Ministry has elaborated a bill supplementing the Law 61-FZ. Pursuant to this bill, the PharmReps

ban. The Bill is currently pending approval within government prior to being introduced before the Duma. Most pharmaceutical companies have already changed the mechanisms of their interaction with physicians. It remains uncertain, however, what methods of control will be exercised by the regulating authorities in order to supervise compliance with the direct contact ban, and what will be regarded as a sufficient proof of a violation in court and in administrative practice after the relevant amendments come into force.

One other mechanism aimed at minimizing third-party influence on a physician administering a drug to a patient has been proposed recently in the Order of the Healthcare Ministry No. 1175n dated 20 December 2012. The Order provides that, starting from 1 July 2013, all drug prescriptions should be issued by physicians with a specification only of the drug's INN, and not of its trade name. Accordingly, the physician will be able to recommend branded drugs verbally when administering a particular treatment to a particular patient, but the final choice will be made by the patient at the pharmacist's counter.

However, not every drug has an INN (this is the case for biological drugs, e.g. hemoderivatives). Currently such drugs without an assigned INN can be classified on an optional basis following the grouping names. In order to make the practice of

the general applicability of the rule restricting the use of drugs' trade names by physicians and public authorities (e.g. in public procurement, medical aid standards).

All the above-mentioned bills and initiatives are expected to become normative Acts and thus to be given binding force during 2013. The trend is to increase the density of normative regulation in the pharmaceutical and healthcare sectors in Russia. At the same time, all federal authorities competent in the relevant area (Ministry of Healthcare, Ministry of Industry and Trade, and the Ministry of the Economic Development) are demonstrating an increasing openness to the public in issues of new regulatory initiatives. And this openness, along with a uniform approach among different regulators in designing the regulatory framework for the pharmaceuticals sector, will definitely help produce the transparent and predictable rules which are currently so strongly demanded by the industry.



All federal authorities competent in the relevant area are demonstrating an increasing openness to the public in issues of new regulatory initiatives

should also become liable for violation of the direct contact ban mentioned above. Substantial fines are provided for in the Bill for the PharmReps and their employers (i.e. pharmaceutical companies) who violate the

the use of grouping names obligatory, one more Bill pending governmental approval (prior to introduction before the Duma) proposes the definition of a "drug's grouping name" into the Law 61-FZ. It aims to secure

BUSINESS

CASES:

CREATING

AN

ENTERPRISE

PART VI



Hakan Danielsson
CEO, OJSC IC Allianz

MERGER OF THREE ALLIANZ OEs IN RUSSIA

Allianz was one of the first international insurance companies to expand into the post-Soviet state and is now one of the largest such ventures, with 92 branches in all federal districts. Allianz has about 6,000 employees in the country and twice that number of sales agents. The Allianz Group companies in Russia, including obligatory medical and life insurance, took about \$1 billion in premiums in 2012.

Allianz entered the Russian market in 1990 by setting up a subsidiary; Ost-West Allianz, which was later renamed CJSC Allianz Russia. In July 2001 Allianz acquired 45.47% of ROSNO's capital and in 2007 became its majority shareholder, which helped Allianz to expand significantly on the Russian market. On 21 May 2007 Allianz SE acquired 100% ownership of Progress Garant insurance company. With the acquisition of ROSNO and Progress Garant in 2007 Allianz became a top 10 insurance group in Russia. So until April 2012 Allianz SE had three independent legal entities and brands operating in Russia.

The Allianz philosophy in Russia is step-by-step development. "Our philosophy has never been that we want to come, grab and win in the first year. It took us 10 years to understand the market. It is naive to think you can come with western standards and compete against companies who may not have the same standards," Allianz SE CEO, Michael Diekmann, said recently in an interviews.

Russia is one of the few remaining growth markets for insurance in Europe. The Russian

market had been growing at a rate of 15% to 20% in recent years. Every year new business lines are being added. However, the penetration remains fairly low, so the market is still quite promising. Market problems include price competition and dumping caused by the aggressive growth strategy pursued by both small and large players possibly aimed at building top-line growth to fatten a company for sale, or to amass cash flow to carry out other projects. High business expenses are another concern. Taking into account the attractiveness and the high potential of the Russian market, but also with due regard to its peculiarities, Allianz has set out to build an efficient and profitable OE that will become the national leader in insurance.

In a strategy re-evaluation at the end of 2010, local management together with Allianz as the shareholder started to analyze various options regarding its Russian OEs: 1) maintain the status quo with three independent companies, 2) sell Progress Garant, or 3) integrate the three OEs. After evaluation of the options and alignment with the shareholder in June 2011, the decision for a full legal and operational integration under the brand of Allianz was taken. The aim was to consolidate Allianz's market share and build a more effective platform for future growth, presenting a single face to the customer. Apart of these reasons, there was the elimination of duplication, reduction of legal complexity and limitation of additional capital requirements against the background of a tightening regulatory framework.

If we bring together similar companies, we can expect a cost optimization effect. However, that is not the only reason in this case: ROSNO, Progress Garant and Allianz Russia had different product lines, and their networks differed in terms of coverage and efficiency. ROSNO, operating since 1991, was a market leader setting standards in health insurance and having strong in sales through its own sales force to large corporate clients.



Hakan Danielsson

Lars Hakan Danielsson was born in 1961 in Sweden. He holds a master's degree in mathematics and worked as an actuary from 1987 till 1991. He then served as Chief Actuary for the Stockholm Re, where he was appointed CEO in 1992. From 1994 he served as Deputy CEO and CEO at various companies. In July 2011 Mr. Danielsson was appointed President of OJSC IC ROSNO, the Russian insurance company of Allianz Group. He led the integration of three Allianz OEs in Russia, ROSNO, Progress Garant and Allianz Russia. In December 2011 he was appointed CEO of OJSC IC Allianz.

Allianz Russia was a leading industrial risks insurer and well positioned in sales through brokers. Progress Garant, established in 1989, was an increasingly profitable universal company, strong in sales through its own sales force to smaller clients. This multi-channel strategy was strengthened in the merger process. Consolidation allowed us to integrate the best practices of each company, thus getting maximum benefit out of it.

We not only integrated the three Russian companies with each other, we also integrated ourselves into the global family of Allianz, leveraging the global strength of the company for areas like big industrial risks, marine and trade credit insurance and also working under the Allianz brand with customer-centric approach and compliant business procedures.

In order to minimize the impact of integration on business and the companies, an extremely short and ambitious timeline was chosen. The goal was to make

the united company fully operational as of the beginning of April 2012. This left less than 10 months for the legal and operational integration of three companies into a single entity, including Allianz branding and making substantial changes in the IT system.

The project implementation called for a simple and pragmatic approach with fast decision-making. There were three main phases. The analysis and design phase, lasted for about three months, and developed concepts for the business model, IT, migration, etc. This was followed by another three-month phase to prepare technical IT implementation, migration, products, training and test concepts. And finally three and a half months were allowed for the roll-out

plans of the 14 work-streams. Several of those milestones were also related to major process adjustments.

It was decided to carry out a legal merger of the three companies on the basis of ROSNO. First preliminary approvals of government agencies (Russian Federal Service for Financial Markets and Russian Federal Anti-Monopoly Service) were obtained and corporate procedures were implemented in all the companies (meetings of the Boards of Directors and general shareholders' meetings). The company lawyers also drafted the necessary legal documents, decisions on additional issues of IC Allianz shares and placement reports and got them registered by the Federal Service for Financial Markets. The launch and completion of the

is that all of them have been previously used and tested in practice in the three integrating companies.

The OPUS software, which is now used for corporate business, has come from Allianz Russia; Diasoft, which is used for medical insurance, from Progress Garant; and KIS, which is used for the retail segment, from ROSNO.

It is important to note that the implementations of new IT-systems enabled us to improve some business processes. For example, in medical insurance the introduction of Diasoft optimized several processes especially in customer service, operations, financial reporting and regional activities. In claims handling, the previous Lombardi system was replaced by an ECD upgraded version of the IT-system used by Progress Garant. The exchange of IT systems resulted not just in more efficient and simplified processes but also provided for more functionality, for example subrogation which was partially done manually, or the possibility to register claims not only in the HO but also in branches as the usage of ECD does not depend on the location.

SAP, which was used in ROSNO in cooperation with colleagues from Allianz Business Services in Bratislava, has become the main financial platform of the new company. Electronic data storage was also inherited from ROSNO. We also run a backup data centre, based on Allianz Hungary, in the event of a global disaster which led to failure of the network resources.

The costs of implementing these programs were minimal: consultations and system adaptations to the business process were not required. However IT-integration required significant effort from the IT-side and was very challenging, especially from migration point of view, due to several migration flows and directions.

HR-integration was aimed at the creation of



The project implementation called for a simple and pragmatic approach with fast decision-making

and implementation phase, which included training, testing, migration and technical IT implementation.

To facilitate the integration the program structure was set-up in a way that it would match the future organization and therefore allow for a smooth transition of project activities to the line function. In total a core team of about 50 employees from all 3 entities and global Allianz experts, supported by 100 business experts (the so-called Subject Matter Experts) worked together in 14 work-streams, with the central project office coordinating the activities. The project was implemented taking an in-house approach without external consultants' support.

Over 820 milestones were monitored in the central project master plan which comprised the key milestones of the project

restructuring process were registered with the tax authorities. In the framework of restructuring, company lawyers also drafted and registered documents on the change of the company name from OJSC IC ROSNO to OJSC IC Allianz. Then OJSC IC Allianz was restructured by way of accession of OJSC IC Progress Garant and CJSC Allianz Russia thereto. All the required activities were carried out within the planned time-frame, which was especially important as approvals and other documents from state bodies were needed.

In the event, it all went very well without any major issues, which shows the importance of good legal work, but also the cooperation on regulatory side should be marked positively.

The new company's IT-platform consists of three main IT-systems. Its biggest advantage

a new company, not just adding employees of the two other companies to ROSNO. As to personnel, we analysed how many employees we would need at headquarters and in the branches to ensure proper operation of the new company. The other issue was a new motivation system for back-office

our sales points and partners all over Russia. For example, in retail we optimised our portfolio by about 60%, which was a real benefit for our customers. We also made sure that the necessary documents would be ready to go live.

tions for Complicated Situations. Allianz is the New Name of ROSNO". Ad placements included billboards in 57 cities of Russia, commercials on six federal TV-channels, ads in the press and entertainment and business Internet resources. The second stage started in the autumn of 2012 with the presentation of a unique service in motor insurance "KASKO-less Certificates". The product was aimed at mass audience rather than a specific segment and was supported by a large-scale mass media and out-of-home advertising campaign.

>>

There's one principle that we followed in our integration process: to ensure business growth in each region and retain all front-offices employees

and for sales as before all three companies had different motivation schemes. Branch consolidation procedure was implemented in over 30 cities, including consolidation of scanning solutions, policy distribution, payments or customer services. In some cities the offices of ROSNO and Progress Garant were even located in one building, with 20 people working in one office and only two in the others. In such cases it was reasonable to move them to one office. On the other hand, in Saint Petersburg until recently there were two neighbouring offices: ROSNO had 300 employees, and Progress Garant about 100. So there was no one-size-fits-all solution; we applied a case-by-case approach. There's one principle that we followed in our integration process: to ensure business growth in each region and retain all front-offices employees.

The process was also influenced by the setting up of a dedicated Allianz Global Corporate & Specialty unit in the company, and therefore implementation of AGCS specific underwriting principles and processes, e.g. participation in international programs, direct interaction between underwriters and large corporate clients and brokers (unlike agent-aided sales).

The final stage of the integration project was rebranding. Allianz carried similar rebranding campaigns in eight countries in 2011. But for Russia it was decided to make the process more long-term and gradual due to high awareness of the ROSNO brand. It was among TOP 3 most recognized and trusted insurance brands in Russia. So it was decided to have two stages of the rebranding campaign.

Our rebranding was a great success — according to the National Agency for Financial Studies¹, the Allianz brand now enjoys a high awareness in Russia. The last stage of rebranding started in April of 2013 with promotion of the new innovative motor insurance product, KASKO XXL, which offers clients claim-handling without collection of police certificates and direct referral to a repair station from the car accident site. The underlying principles of integration and rebranding are the reduction of complexity in business processes, product lines and client service.

Another important target included updating the product line. We wanted it to be as close to the Western product range as possible. Optimising and setting up a new product line for the company required a lot of effort as it included not just making a decision in favour of one or the other product but also designing new blank forms of insurance documents, and their distribution to

During the first, which started in April 2012, all our offices and points of sale were revitalized with the use of Allianz ROSNO duo brand, and in March 2013 we switched over to the single Allianz brand. Our final task is to make Allianz offices in Russia look the same as in other countries of the world. The first stage of the nationwide rebranding campaign started with the slogan "Simple Solu-

¹ In December 2012 the National Agency for Financial Studies published the results of the survey according to which Allianz ranked among TOP 3 insurance brands by aided brand awareness and TOP 2 by unprompted awareness.

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Svyatoslav Smirnov

ROOTING IN RUSSIA: THE FERRERO CONFECTIONARY FACTORY IN THE VLADIMIR REGION

In 2007, Ferrero took a decision to build its own plant in Russia, seeing this as a natural continuation of Ferrero's development strategy in the Russian market. Specialists from Italy and Germany in cooperation with the management of Ferrero Russia thoroughly analysed several possible production sites located in the central federal district. The key features while choosing the place for the future factory were: the legal status of the land, its compliance with technical requirements, the level of local infrastructure and the availability of skilled personnel. Another feature was also taken into account, namely the availability of an appropriate local authority which is interested in attracting foreign investment and facilitating investment.

After careful analysis, Ferrero opted for a site in the Vladimir Region, one of the most promising economic regions of central Russia. The stable socio-economic situation, high educational and qualification level of the work-force, the developed domestic market infrastructure were all factors offering a stable base for regional economy development and which make the Vladimir Region very attractive for the foreign investors. Also the administrative resources of the

Region are actively used to assist investment projects.

In May of 2008, Ferrero began to build its first Russian factory, with a total investment of more than EUR 200 million.. Despite the world economic crisis in 2008, the project was not stopped and the construction was completed on time.

In early May 2008 a competition for key positions in the new factory was held. Within a year all top and middle management was found. The financial, human resources and information technology departments began work in the spring of 2009. The recruitment of core production staff was launched in August 2009. By 2010, with the launch of the second production line, 500 new jobs had been created.

Nowadays the Ferrero confectionary factory in the Vladimir Region (Vorsha village, Sobinsky district) is a modern production and logistics complex with a total area of 80,000 m². It is the second-largest Ferrero confectionary factory in Eastern Europe, and has created more than 1,000 jobs. It has four production lines manufacturing the key brands of the company: Kinder Choco-

In 1995, the Ferrero Group opened its first office in Russia and entered the market with its products such as Raffaello, Kinder Surprise, Kinder Chocolate, Nutella and Tic Tac. Ferrero group interests in Russia were presented by JSC Ferrero Russia, a Russian company with 100% foreign ownership. Ferrero Russia has developed from a small Moscow representative office to a large manufacturing company with an extensive distribution network throughout the country. After 18 years of sustainable growth, Russia is now in fourth place in Ferrero Group turnover after Italy, Germany and France. At the moment, over thirteen Ferrero brands are available in Russia.

late, Raffaello, Nutella and Kinder Surprise. The factory is based on the latest high-tech manufacturing technologies. There is the obligatory quality control at the factory, which guarantees the authentic taste of the products.

For day-to-day operations, Ferrero aims to use local companies wherever possible. Most service providers are Vladimir Region businesses. As of late December 2012, the total investment of Ferrero in the Vladimir Region amounted to about EUR 250 million. Today, it is the most important investment project in the area.

Milestones in the history of the Ferrero factory in the Vladimir Region:

- 27 May 2008: the "first stone" construction ceremony
- November 2009: the launch of the first production line for the manufacture of Kinder Chocolate
- March 2010: the launch of the Raffaello line
- May 2011: the launch of the Nutella spread line
- September 2012: the launch of the Kinder Surprise line

Ferrero Russia — a socially responsible investor in the Vladimir Region:

The Ferrero Group in Russia is fully aware of its social and environmental responsibilities which are well recognised.

On 27 May this year the Ferrero confectionery factory in Vladimir Region celebrated its 5th anniversary. One of the highlights of the event was the presentation to Ferrero Russia of a letter of gratitude from the Vladimir Region administration and acting Governor, Svetlana Orlova, for the successful implementation of the investment project and for the company's contribution to the development of the region's economy and social sphere.

From the start of its operations in the Vladimir Region, Ferrero Russia has launched a number of social initiatives locally. These are carried out together with the Administration of the Vladimir Region. The stakeholders define key areas, resources and efforts needed to

achieve the goals which are, primarily, aimed at the protection and support of orphans and children in adoptive and foster families.

A remarkable example of the Vladimir Region Administration and Ferrero Russia's effective cooperation in the social area was the agreement to support the "VideoPassport" project, an information retrieval system for adoptive parents. Within Ferrero and the Education Department of the Vladimir Region Administration agreement, Ferrero Russia financed the production of 50 VideoPassports for children without parental care who live in the Region's orphanages. To date, 28 children have found new adoptive families, thanks to this project.

Another important social initiative became the "Kinder + Sport" project which the company supports in cooperation with the Department of Sports of the Vladimir Region Administration. In the last few years, lots of children's sports events have been held.

More than 2,000 children took part in games and competitions in the frame of this cooperation. Besides, Ferrero Russia regularly supports various sports and cultural events held by the Special Olympics, a public charity organization of the Vladimir Region for the disabled people with mental retardation.

The company annually holds children's events dedicated to the Day of Protection of Children, to which children in the orphanages of the Vladimir Region are invited. Besides supporting targeted activities conducted by the Regional Administration, Ferrero Russia regularly gives traditional sweet gifts to orphans at Easter and Christmas.

The active cooperation of Ferrero Russia, a major foreign investor, and the Administration of the Vladimir Region is an excellent example of effective foreign economic relations built between Russia and Italy.

Association of European Businesses

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ABOUT THE AEB

Founded in 1995, the Association of European Businesses is an independent non-commercial association with a membership of companies from across the European Union and the Russian Federation. AEB members range from large multi-national corporations to small and medium-sized enterprises (SMEs). They are united by their commitment to forging stronger economic ties between the European Union and the Russian Federation, as well as improving the business environment here in Russia.

AEB MISSION

The AEB represents and promotes the interests of European companies conducting business in and with the Russian Federation. The AEB promotes economic integration and partnership between the Russian Federation, European nations and the European Union.

POLICY

The AEB has a significant voice in policy-making in the Russian Federation, and is a forum for dialogue between international businesses and the Russian government, lobbying actively on behalf of its members. For over a decade, the AEB's lobbying initiatives have encompassed a wide range of issues of importance to all sectors and industrial areas covered by its Committees. Furthermore, the AEB engages in dialogue with European and Russian administrative bodies to promote the interests of AEB member companies:

- EU Delegation to the Russian Federation (RF);
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- Russian Union of Industrialists and Entrepreneurs;
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- Foreign Investment Council (FIAC);
- European Bank for Reconstruction and Development (EBRD);
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FOR NOTES

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