

AEB *HOW TO INVEST IN RUSSIA*

THE AEB GUIDE TO INVESTING IN RUSSIA



**MAXIM ORESHKIN**

Minister of Economic Development
of the Russian Federation

Dear colleagues,

Creating favourable conditions for business is one of the key preconditions for higher investment activity. A set of measures to improve the statutory regulation of business activity has been implemented over the past several years and the infrastructure for investment project support is in the process of improving. This work has allowed Russia to climb to 35th place in the World Bank's Doing Business rating, thus demonstrating stable improvement in its position in the rating.

The mechanism for managing the systemic changes in the business environment – Business Climate Transformation – is currently being formed, which is intended to lift the current regulatory restrictions on business activity, including the elimination of excessive, outdated and contradictory requirements contained in the regulations. The adopted measures will provide stable macroeconomic conditions and the foundation for economic growth.

Work on improving the investment climate in Russia is carried out in cooperation with the business community, including with the participation of the Association of European Businesses. This makes it possible to objectively and precisely calculate the advantages and costs, reduce the risks, and assess the impact on the business climate and investment attractiveness during the decision-making process.

We are open for cooperation and are ready to promote the successful implementation of business ideas of foreign investors in Russia.

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Association of European
Businesses

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Chairman, Finance & Investments
Committee, Association of
European Businesses

Dear readers,

Welcome to the 2018 edition of the AEB “How to invest in Russia” guide.

The past year has been dominated again by the geopolitical situation, with a continued deterioration in Russia’s relationship with the West creating an environment in which the economy has not been able to recover as quickly as it might. This is due primarily to a poor investment climate that has prevented needed improvements in productivity to offset the upcoming demographic challenge. In addition, the geopolitical tension has caused further pressure on the rouble that has prevented the Central Bank from making further interest rate cuts and stimulating corporate lending.

The administration’s conservative policies in relation to fiscal discipline, alongside the Central Bank’s commitment to inflation targeting, have been endorsed by leading economists, the IMF and rating agencies. With combined low public and private debt, adequate foreign exchange reserves and a positive balance of payments, Russia is approaching the coming period in a relatively strong position in the short term; issues that exist relate more to long-term development and future prospects.

That said, the highly-charged political environment has meant that ‘event’ risk has substantially increased, and there is now an inevitability to the potential for severe counter-actions from Russia in the event of further sanctions from the West. AEB reaffirms its position in favour of the de-escalation of conflict and

remains opposed to economic sanctions or limitations on free trade or investment. It is incumbent on all parties to maintain dialogue within the business environment to seek a means to de-escalate the current tensions.

Apart from the direct impact of sanctions, which reduce GDP growth, increase the country risk premium, create pressure on long-term funding and fuel inflation, there are the indirect impacts of higher interest rates, capital and intellectual flight, and a loss of confidence of domestic investors and consumers. Given the political nature of the drivers, it is no longer possible to forecast how long these negative influences will last and how deeply they will impact the economy.

However, the Russian economy of 146 million people will continue to present tremendous opportunities for investors who are prepared to accept the risks involved in working here. The AEB survey of European investors acknowledges the increased risks of the operating environment, but also notes the consistently more positive perspective of those with existing investments.

This current edition of the “How to invest in Russia” guide will bring you updates on the investment climate and legal, financial and environmental aspects. In addition, it also provides insight into investments by regions and by industries, as well as into opportunities and challenges when localising in Russia.

We would like to thank all the authors who helped by making their valuable contributions to this guide and sharing their knowledge of the Russian market and their experience of running a business here. We are also 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 promote a business environment which is beneficial to all interested parties.

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Part I.

Russia is the right place for investing

Changes in the legislation and state policy of control over foreign investments



GRIGORY KARAKOV

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In 2012, received a bachelor's degree with honors at the Moscow State Institute of International Relations (University), MFA Russia, and in 2014 earned a master's degree.

From 2012 to 2015, worked as a State Duma Deputy Assistant on a voluntary basis.

From January 2013 to March 2015, worked as Deputy Director General at Decor Line, LLC.

Member of the Federal Antimonopoly Service from March 2015. Promoted from a Senior First-Class Specialist of the Pre- and Post-Merger notifications examination division at the Foreign Investment Control Department to the Head of the Division. Since March 2018, serves as Deputy Head of FAS Department for Control over Foreign Investments.

Member of the Expert Council at the State Duma Energy Committee and member of the Expert Council for Foreign Investments at the FAS Russia.

2018 is a rather symbolic year for anyone involved in control over foreign investments in Russia, as it is the 10-year anniversary of Federal Law No. 57 of April 29, 2008 "On the Procedure for Making Foreign Investments in Business Entities of Strategic Importance for National Defense and State Security" ("Law No. 57-FZ"), the Government Commission for Control over Foreign Investments in the Russian Federation ("Government Commission") and the Department for Control over Foreign Investments, or the core structural unit of the Federal Antimonopoly Service.

Over the past 10 years, legal regulations have moved forward, with three successive packages of amendments to Law No. 57-FZ adopted in 2011, 2014 and 2016 aimed to reduce the sphere covered by law and specify its norms. Today, the 10-year anniversary is no exception.

In particular, in 2016 Law No. 165-FZ amended Federal Law No. 160-FZ of July 9, 1999 "On Foreign Investments in the Russian Federation" ("Law No. 160-FZ"), making the transactions of foreign investors with respect to Russian business entities, including those of no strategic importance to national defense or state security in the meaning of Law No. 57-FZ, eligible for submission to the Government Commission for consideration to ensure

national defense and state security by decision of the chairperson of the Government Commission (see journal release No. 01, 2017 for details).

In 2018, to reduce uncertainty about the procedure for applying this norm, amendments were also made to Government Resolution No. 510 of July 6, 2008, which approved the Regulations on the Government Commission for Control over Foreign Investments in the Russian Federation ("Regulations"). The Regulations specify the procedure and period for processing information received about relevant transactions and making decisions on their preliminary approval.

According to the Regulations, to determine whether it is necessary to inform the chairperson of the Commission about a transaction, the FAS, within five business days after the competent authority becomes aware of the expected transaction, shall send requests to the federal executive authority responsible for the regulation of the industry in which the company operates, as well as to other authorities and organisations concerned, in order to submit their proposals on whether the chairperson of the Commission should be informed of the transaction.

Based on the assessment of the possible consequences of the transaction,



The Regulations specify the procedure and period for processing information received about relevant transactions and making decisions on their preliminary approval.

the authorities and organisations that received requests shall within 15 business days send their proposals to the FAS of Russia on whether the chairperson of the Commission should or should not be informed of such transaction.

If it is proposed that the chairperson of the Commission be informed of the transaction, the competent authority shall within five business days provide the chairperson of the Commission with information about the

expected transaction. If the chairperson of the Commission decides the transaction is subject to a preliminary approval, the FAS of Russia shall within three business days inform the foreign investor and Russian business entity thereof.

Thus the above norm does not introduce any additional obligation for foreign investors to apply to the competent authority regarding preliminary approval of transactions if it

is not expressly provided for by Law No. 57-FZ, Law No. 160-FZ or Federal Law No. 135-FZ of July 26, 2006 "On the Protection of Competition". A foreign investor planning a transaction should take into account that given the exclusivity of its application, the norm in question does not apply to transactions. It should be noted that over the entire period of said norm's existence, the chairperson of the Commission has been informed of two transactions, neither of which has so far been submitted to the Government Commission for consideration.

However, the main achievement of the past year is the adoption of Federal Law No. 122-FZ of May 31, 2018 "On Amending Individual Legislative Acts of the Russian Federation to Specify the Term "Foreign Investor" ("Law No. 122-FZ").



In July 2017, under the banner of de-offshorization, Law No. 155-FZ prohibited control of strategic companies and their property for all investors owning offshore companies.

Law No. 155-FZ seriously restricted investments in the Russian economy not only from the East and West, but domestically as well.

In the context of the economic sanctions imposed on Russia and Russians by a number of countries, the introduction of artificial barriers by the Russian government in respect of its own citizens for investments in

the economy is indeed a disputable decision.

The jurisdictions subject to the ban were chosen based on the "List of countries and territories offering beneficial tax treatment and/or requiring no disclosure or submission of information for financial operations (offshore zones)" approved by the Ministry of Finance of the Russian Federation.

Considering that disclosure by foreign investors of financial information about the persons who influence their activities on a variety of grounds is an

essential element of control over foreign investments, in June 2018 the norm concerning offshore companies changed, and Law No. 122-FZ made amendments to Law No. 57-FZ by introducing a new type of foreign investor instead of offshore companies: an investor that does not submit information to competent authorities about its beneficiaries, beneficial owners or controlling persons.

Thus, similar to foreign investors and international organisations, as well as their controlled organisations, including those founded in Russia, the above category of foreign investors is subject to a direct ban (without any alternatives) on transactions, other actions entailing control of strategic business entities, and/or transactions for the acquisition of property, whether for ownership, possession or use, categorised as fixed production-related assets, the cost of which is 25 or more percent of the balance-sheet value of their assets.

This approach helps improve control over foreign investments by imposing restrictions not based on territorial or national affiliation, but on the submission by foreign legal entities and foreign organisations (not legal entities) of information to competent authorities about their beneficiaries, beneficial owners and controlling persons.

In particular, the FAS of Russia regularly deals not with companies from offshore zones that do not submit information about controlling persons, but rather with companies from countries or territories not included in the above list (for example, the Republic of Cyprus) that refuse to provide the necessary information.

Moreover, to apply the effective exemptions from Law No. 57-FZ (for example, to foreign investors controlled by tax residents of Russia without other citizenship (Part 9, Article 2, Law No. 57-FZ), competent authorities must obtain information about the persons controlling the beneficiary under the transactions to confirm their application.

The obvious disproportion between the status of offshore companies submitting information to competent authorities and foreign countries and international organisations is also worth mentioning: the first are private investors who are generally lower in the ownership structure of the transaction beneficiary than end controlling persons, in other words a foreign individual or corporate entities (in particular, public companies with listed shares). The main difference between offshore companies and foreign states is that an offshore company may in part be owned by a citizen and tax resident of Russia who has no other citizenship.

In this context, the differentiated approach introduced by Law No. 122-FZ eliminated the priority position of certain foreign investors over others for transactions with assets of strategically important companies and ensured equal access for foreign investors to share in the privatization of public and municipal property, which as a whole will eliminate discriminatory conditions for foreign investments in Russia, contribute to further promotion of competition and improve the investment climate in Russia.

Currently, the FAS of Russia has developed its Rules for the provision of information to the federal executive

authority responsible for control over foreign investments in Russia ("Rules") about the beneficiaries, beneficial owners and controlling persons of foreign legal entities and non-legal entity foreign organisations and their controlled organisations.

According to the draft document, in regards to transactions or other actions subject to preliminary approval by the Government Commission, applicants are to provide information to the competent authority as part of their applications for the preliminary approval of transactions, other actions

Investors need not wait for any additional confirmations from the FAS of Russia, and foreign investors automatically acquire "disclosed" status as soon as they provide full information.

or petitions for approval of control in accordance with the rules approved by Resolution of the Russian government No. 838 dated October 17, 2009 "On the approval of Rules for the preliminary approval of transactions and approval of control over foreign investors or groups of persons foreign investors belong to, and business entities of strategic importance for national defense and state security", or under the procedure prescribed by these Rules.

Thus, it is expected that foreign investors intending to make a transaction with a strategic company and prepared to disclose information to the regulator about its beneficial owners, beneficiaries and controlling persons, may disclose such information immediately in its petition or in

advance in accordance with the Rules, or by sending a request as per Part 6, Article 8, of the Law. In all three instances, the Law's requirement to "provide information" will be fulfilled, and consequently such foreign investor will not be subject to any stricter regulations under the Law.

Information will be deemed provided to the competent authority by the applicant as of the date of its submission in the scope prescribed by the Rules, if it remains valid as of the transaction date. In other words, investors need not wait for any additional confirma-

tions from the FAS of Russia, and foreign investors automatically acquire "disclosed" status as soon as they provide full information.

However, to apply the exemptions and exclusions provided for by Federal Law, applicants must submit information no later than 30 days before the expected transaction date. This means that until foreign investors submit information about their beneficiaries, beneficial owners and controlling persons to the FAS of Russia, the exemptions under Law No. 57-FZ, for example, under Part 9 of Article 2, Part 4 of Article 4, Clause 3 of Part 1 of Article 7, will not apply to them, and such investors shall be subject to the norms regulating the activities of foreign investors that have not submitted information.



Moreover, if information in the scope prescribed by the Rules was submitted to the FAS of Russia earlier as part of petitions or notifications submitted in accordance with Law No. 57-FZ or Law No. 135-FZ and remains valid, such investors shall also be considered "disclosed".

Furthermore, the "disclosed" status remains in effect for investors without any time limitations throughout the entire period the submitted information is valid.

Operations are simplified even further for public companies of investment funds, which can provide information in the form of a link to a website where such information is disclosed in the scope required by the Rules.

If the information disclosed is a commercial, official or other legally protected secret, the applicant shall make a list of confidential information, and the competent authority ensures the confidentiality of such information and shall be held liable for its disclosure.

Another new aspect introduced by Law No. 122-FZ enshrined the right for the FAS of Russia to provide explanations regarding its application of the Law in question.

Thus, due to the possible multiple interpretations of Law No. 57-FZ, it is not always clear whether transactions need to be approved or are subject to other actions in certain circumstances, for example, is it possible to control a foreign investor through a foreign natural person acting as its sole executive body.

Before the above changes, the FAS of Russia did not have the legal authority to examine the applications of natural or corporate persons as regards the application of Law No. 57-FZ. Addressing this gap will facilitate the use of a more flexible approach by the FAS of Russia to the interpretation of law provisions with regard to the formation of law enforcement practices (by analogy, with the explanatory work carried out by this body within the scope of anti-monopoly legislation and expressed, in particular, in the standpoints of the Presidium of the FAS of Russia reflecting the position of the FAS of Russia with respect to disputable law enforcement issues).

However, explanatory work is not exclusive to the Presidium of the FAS of Russia, but can also be pursued by the Federal Antimonopoly Service in the

preparation of responses to applications, as well as by the Public Reception of the FAS of Russia and on its official website.

Based on the scope of this article, the Federal Antimonopoly Service has made significant improvements to the legislation concerning foreign investments. The amendments made are in line with the trend towards liberalizing Law No. 57-FZ and abandoning unreasonable restrictions and bans in the context of unconditional observance of national defense and state security requirements. Moreover, legislative norms are further specified in the form of by-laws.

The experience of foreign countries in regulating foreign investments is also analysed as a whole, and in controlling foreign investments in sensitive economic sectors, in particular. The FAS of Russia weighs all the pros and cons of approaches used in the USA (in existing laws and expected amendments), Great Britain, France, PRC and a number of other countries. Generally speaking, analysis reveals that the Russian treatment is far from the toughest, its procedures are transparent and clear for foreign investors, and the legislation has no hidden "snags".

Further development of Law No. 57-FZ will continue in a similar vein of selective adjustments specifying the "game rules" based on ten years of experience in the Government Commission and the FAS of Russia as a competent authority for control of foreign investments in Russia, as well as the best global practices in the context of the Russian legal framework. ■

Business climate in Russia: AEB-GfK survey 2018

AEB published the results of the Annual Survey “Strategies and prospects for European companies in Russia”



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Managing Director, GfK Rus

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In 1991, Demidov established GfK Rus, the Russian branch of GfK SE, and since then he has been the Managing Director and CEO of the company.

Since 2005 he has been the head of GfK Rus department of the Sociology Faculty at the Higher School of Economics.

Alexander is one of the Top 250 top managers in Russia according to the joint rating by the Kommersant newspaper and the Association of Managers.

key challenges and strategies faced by European companies doing business in Russia. This year the survey was conducted in March-April 2018 in cooperation with the International Institute of Marketing and Social Research GfK Rus.

The uniqueness of this year’s survey is that the data collection stage coincided with important events – the presidential election in Russia and the announcement of a new package of US sanctions against Russia – and captured the mood of European business during this period.¹ What has the greatest impact on business?

The survey results demonstrate that the majority of the European companies in Russia were satisfied both with the results at year-end 2017 and at the beginning of Q1 2018. However, weak growth in the Russian economy added to the air of uncertainty. 29% of companies noted that the overall state of the economy in early 2018 was developing worse than they expected (in 2017, this was 14%).

But one of the most destabilising factors is the risk of sanctions, which spoils the positive business climate for European companies in Russia as a whole. In the opinion of the study participants, the sanctions against Russia

and the results of the US election had the most negative impact on the business of European companies in Russia. As compared to 2017, the share of respondents who negatively assess the impact of these factors on company operations and the Russian economy has increased:

- 75% of companies said that sanctions against Russia had a negative impact on their performance in Russia (in 2017, 66%);
- 47% noted that the election of Donald Trump as president of the United States adversely affects the activities of their company (in 2017, 8%);
- 39% pointed to the negative impact of Russian sanctions on the EU and US (in 2017, 39%).

In the members’ opinion, the above factors have the most negative impact not only on their company, but also on the economy of the Russian Federation as a whole.

Regarding the influence of the Russian presidential election results on the business of European countries, the majority (67%) of companies believe that the economic policy of the Russian Federation will not change after the 2018 election (the survey was conducted from March 26 to April 26, 2018).

The AEB published the results of the 11th AEB Annual Survey “Strategies and prospects for European companies in Russia,” which characterises the state and attractiveness of the Russian investment climate and highlights the

¹ The survey was conducted from March 26 to April 26, 2018.

► **AEB-GfK barometer: business expectations in Russia**

AEB-GfK Index Dynamics



Integrated index



The impact of the economic policy of the Russian government on company operations is estimated neutrally or positively by 61% of respondents and negatively by 34% of respondents.

As a result of the growing discomfort from the possible risks of doing business in Russia due to external factors, in 2018 the Complex Index of the AEB-GfK showed the sentiments of European business decreased by 3 points compared to 2017, amounting to 138 out of 200 possible points.

In connection with negative external factors, the share of respondents who expect a reduction in investments in

Russia as a whole increased from 11% in 2017 to 36% in 2018. However, most companies expect that investments in their types of business will remain unchanged.

Most companies expect the Russian economy to either stagnate or grow in the short-term (1-2 years). The good news is that the long-term (6-10 years) and middle-term (3-5 years) economic prospects remain high.

This fact allows us to conclude that European companies in Russia continue to believe in the Russian market. The survey showed that in 2018 almost two-thirds of companies were counting

on increased profits, whereas in 2017 there was a slim majority of such companies.

Why are there good prospects for the Russian market? The main reasons for entering the Russian market continue to be the large size of the market, great market potential, and positive market dynamics: 93%, 90%, and 90%, respectively, of the companies noted these reasons as the most important.

The financial conditions of AEB member companies are still quite acceptable: as a rule, less than 20% of payments are made late, and late payments usually do not exceed one month. In addition, 21% of companies never had bad debts.

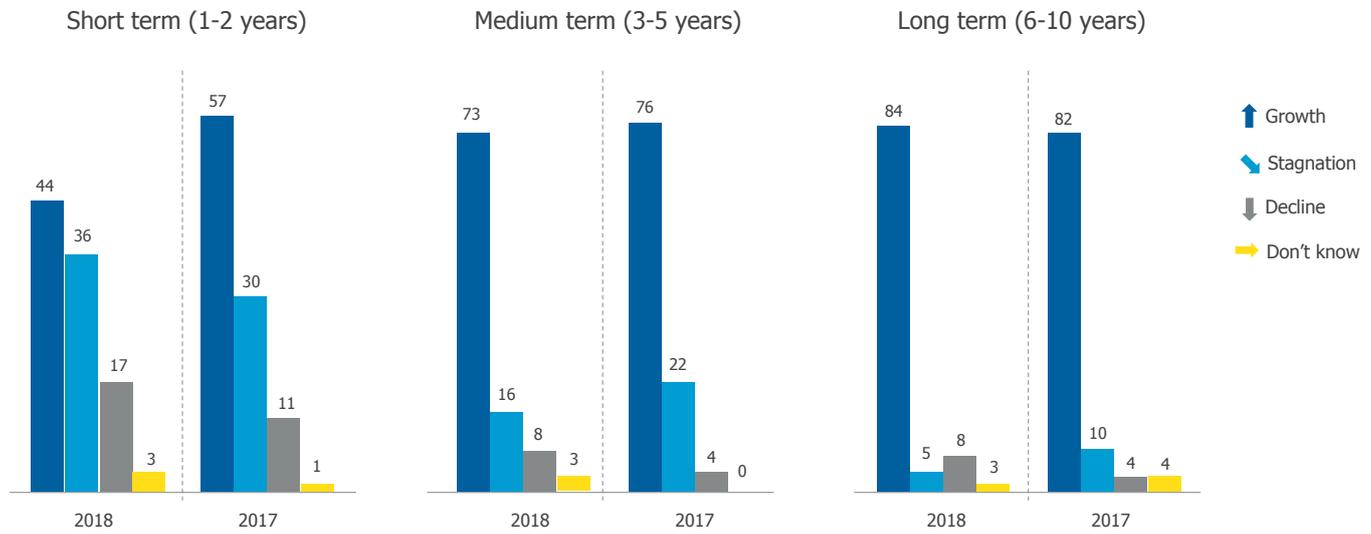
More than half of companies (62%) went to court to recover debt, and the majority of the cases were successful.

What are the areas of improvement of the business climate in Russia?

The business culture and business environment of the country have a modest rating among the European companies currently operating in the market. Work with legislative, customs, tax, and other authorities is rated rather negatively.

Regulatory restrictions are a major barrier to business (62% of companies mentioned regulatory restrictions as the main barrier to business). Another important problem is the lack of qualified personnel (30% of companies noted the lack of qualified personnel as a major barrier). 22% of companies named the lack of reliability of the supply chain as a key barrier to business.

► Economic outlook for Russia in the coming 10 years, %



The main problems related to financing remain the high interest rates (29%) and lack of cash flow/available financing (29%).

Although most AEB members do not expect an improvement in the situation with regard to bureaucracy, taxes/fees, and corruption (58%, 58%, and 57% of companies, respectively,

do not expect improvement in the next two years), these areas can be the main areas of improvement, which will make the Russian market more attractive to new potential investors.

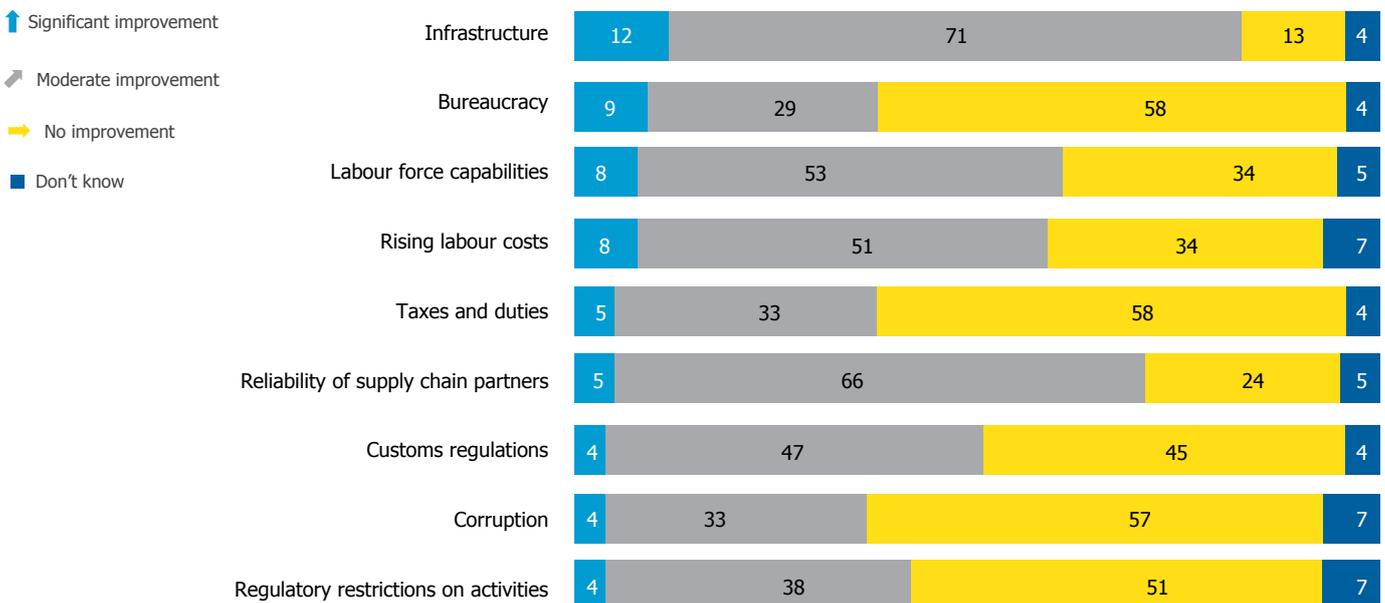
About the survey

The "Strategies and Prospects of European Companies in Russia" study is carried out by the International Insti-

tute of Marketing and Social Studies GfK Rus at the AEB request.

This year's study was carried out for the eleventh time through on-line surveys and personal interviews with top managers of AEB member companies operating in Russia. The number of participants varies from 76 to 109. █

► Expectations for improvement in different operating units over the next 2 years, %



The Kaliningrad region: the legacy of the 2018 FIFA World Cup in Russia



DENIS SALIY

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Born on 27 March 1983 in Krasnodar.

Denis has three higher education degrees: legal, state and municipal management, MBA.

In December 2016, he was nominated to the Council for the improvement of the investment climate in the Kaliningrad region.

In March 2018, he was appointed Head of the Representative Office of the Kaliningrad region Government under the Government of the Russian Federation in Moscow.

On 20 July 2018, Vladimir Putin, the President of the Russian Federation, held a special meeting in Kaliningrad where the first results of the 2018 FIFA World Cup were announced. The preparations for the FIFA World Cup in Russia lasted 8 years. The Governor of the Kaliningrad region Anton Alikhanov chaired the working group on prepara-

tions for the event and the formation of offers for the concept of the tournament's legacy.

The main issues discussed were further use of sports facilities, infrastructure (sports arenas, airports, roads) and the development of cities.

State support for development programmes of the championship facilities is available for five years, with the expectation that by 2024 they become self-sufficient and serve as centres of development for cities and public, business and cultural life.

All matches were held with full stands, and the total ticket programme topped 3.32 million people, or an average of 47,000 viewers at every match. More than 100 billion roubles were spent in the service sector by our guests.

As for the legacy of the 2018 FIFA World Cup in the Kaliningrad region, we note that beyond the sporting event, the World Cup was marked by serious investments in the infrastructure of the region, which have since created the necessary conditions for business development. The tournament also contributed to the economic and social development of the region and helped increase the tourist flow. During the group matches, a total of almost 260,000 fans visited the region, with over 105,000 foreign guests.

Hosting games has become a powerful incentive to increase tourist flows, including from abroad.

Renovated in anticipation of the Mundial, the Khrabrovo Airport can handle 3.8 million passengers annually. During the 2018 FIFA World Cup, more than 70% of fans travelled to the Kaliningrad region by plane (as a reminder, four matches were held in Kaliningrad: Croatia-Nigeria, Serbia-Switzerland, Spain-Morocco and England-Belgium).

Now we are seeing a large number of foreign tourists who immediately after the championship took the opportunity to visit Kaliningrad again by FAN ID for a longer time.

The tourist flow, which before the event increased annually by 10%, shot up by a factor of 18. During the World Cup, the Kaliningrad region welcomed foreign tourists from England, Spain, Serbia, Croatia, Switzerland, Belgium, China and other countries. Hotels in the region were fully booked at 97.6%.

When the World Cup was in full swing, international automobile checkpoints at the border with Poland and Lithuania were staffed to handle the maximum load, and worked in a specially designed reverse mode, where the time to pass one car was no longer than five minutes. We plan to consolidate this successful practice of applying a re-

versible traffic scheme at international car checkpoints during peak loads.

In short, all the joint efforts of the government, private businesses and volunteers were aimed at making tourists love the region and want to come back. The average consumption of one foreign tourist in Kaliningrad and the outskirts of the city during the World Cup was more than 30,000 roubles.

For FAN ID owners, the visa-free regime has been extended through 1 January 2019. Furthermore, in 2019, a new regime will be rolled out to allow foreign citizens visiting the Kaliningrad region, to promptly receive electronic visas with a term of stay in the region up to eight days.

These conditions ease the burden on tourists, and will also help investors localising business and production facilities in the Kaliningrad region.

The Kaliningrad region Free Economic Zone has 185 residents and a total cost of announced projects at more than 118 billion roubles. Among them, in just Q1 2017, foreign investment tops 16,014.9 roubles. The unified state register of legal entities with the participation of foreign capital currently contains more than 640 operating enterprises.

Investors from more than 70 countries implement their business projects in the region and this figure is growing steadily.

Since January 2018, there are already 7 major investment projects in varying degrees of implementation. They include companies in IT, agriculture and metalworking. Baltinoks is a Lithuanian company and one of the largest suppliers of stainless steel products to the Russian market. It plans to open



its own branch in the Khrabrovo industrial park and supply its products domestically and abroad, with total investments of around 10 million roubles. One of the founders of the Norwegian-Danish company RBPi is investing in the project for the production and sale of pig products for a total of 3 billion roubles.

In general, foreign investment for us is a kind of quality guarantee of the investment attractiveness of the region. Yet the guiding principle formed by the Head of the Government of the Kaliningrad region is as follows: we do not divide investors by nationality, and we work with all investors according to the same rules.

The rules are as follows: to become residents of the special economic zone (SEZ), the company needs to indicate their intention to invest at least 1 million roubles in the first 3 years. After obtaining the status of a SEZ resident, the company can enjoy all its benefits and preferences.

For example, the minimum threshold of 1 million roubles applies to IT companies and scientific research activities. In the medical industry, the minimum is 10 million roubles in 3 years, and

50 million roubles for projects in the tourism and recreational sector, processing industry, agriculture and fisheries. For other types of economic activity, the investment threshold is set at 150 million roubles.

Residents of the Kaliningrad SEZ also enjoy tax preferences for income tax and property tax: 0% during the first 6 years of project implementation, and a 10% income tax and 1.1% property tax from 7 to 12 years. The first 6-year period for income tax will start from the moment of receipt of the first profits from the project. Enterprises that received SEZ resident status within 7 years will also be able to apply for reduced insurance premium rates of 7.6%, provided the creation of new jobs.

Other benefits and preferences are also envisaged, such as reduced administrative terms of state expertise, guarantees of the invariability of the aggregate tax burden, simplified procedure for obtaining land for rent, and more.

Undoubtedly, one of the main advantages of the Kaliningrad region for businesses is the combination of the special economic zone and free customs zone, which applies to the region as a whole. Currently, in terms of

tax burden and costs, the Kaliningrad region is objectively the most attractive area to do business in, including among foreign investors.

For investors in the Kaliningrad region legislation has set a 0% customs duty on the import of goods, raw materials and components. There is no import VAT, and a 180-day deferment period applies to the export of import goods to the main territory of the Russian Federation. Moreover, there are no quotas for the import of goods, raw materials or components into the Kaliningrad region.

Another unconditional advantage of the Kaliningrad region is its well-developed logistics and transport infrastructure. The region is home to a single ice-free port in the Baltic. Unique opportunities for the development of transit and export projects are also made possible by the presence of two railway track types: wide-track (EAEU countries) and narrow-gauge (European). The region is criss-crossed by trans-European automobile transport corridors and there is also an airport with the 5th freedom of air.

The Kaliningrad region has real promise to become the home base for foreign producers looking to enter the markets of the EAEU, and domestic producers to enter the markets of the EU and Southeast Asia. This is helped immensely by its geographic position as the most westward region of Russia because it is closest to the industrialised countries of Europe, which are potential markets and sources of investment. The Kaliningrad region with its low costs, tax benefits and affordable industrial park infrastructure, is an ideal platform for the production of a competitive product and market access to Russian and international markets.

In March 2018, the Kaliningrad stadium hosted its first event, with seating for 35,000 spectators, making it the most compact stadium among the newly built facilities for the Mundial. With the stadium's completion, the engineering preparation of the Oktyabrsky Island was finished, granting Kaliningrad development prospects of more than 130 hectares in the city centre with roads and engineering infrastructure.

To supply the football stadium with electricity, the first closed-type substation of 110 kilovolts was built in the Kaliningrad region.

In fact, this is quite timely, considering the fact that in autumn 2018 the island will adopt a special administrative category featuring special tax regimes and no currency control. This special jurisdiction has captured the interest of such financial companies as Rusal, Vnesheconombank, Gazprombank and others.

As for the cultural heritage of the championship, Oktyabrsky Island near the Kaliningrad stadium will become the new home to a modern Cultural Centre (more than 238,890 m²), including a branch of the Bolshoi Theatre, a choreography school, a special boarding school for children, a conservatory, a museum complex with support from the Tretyakov Gallery, Hermitage, Russian Museum, theatre and schools from adjacent territories.

Since the area is a legacy of the World Cup, all sites are equipped with the necessary infrastructure, which will facilitate the quickest possible route for the Kaliningrad region, as a special region of Russia, to become an outpost of the Russian culture.

Three training fields were also reconstructed in Kaliningrad, a new field was constructed in Svetlogorsk, 10 new hotels of various types were opened, and 3 clinics and 17 transport facilities were reconstructed. In many ways, these advancements were all thanks to the FIFA World Cup.

Of course, we expect this will also facilitate a substantial increase in the tourist flow, as well as the emergence of new business investors.

If we talk about the most promising sectors in the Kaliningrad region, at the moment we can highlight: automotive and mechanical engineering, shipbuilding and ship repair, the agro-industrial complex and fish industry, food production (in this field we can look to the successful experience of SEZ resident Hipp, a German company which localised a factory for the production of baby food in the Kaliningrad region, investing 15 million Euros), the pharmaceutical industry; IT and microelectronics, the development of which is ensured by the largest cluster in the electronic industry in Europe (Technopolis GS), media and film production (the system of returning part of the costs for filming has been rolled out in the region, and the development of a movie cluster is planned); tourism and medical tourism (we are also working out all the options for partnering with European colleagues in the near future open to cooperation), and our traditional amber jewelry production industry (currently primarily of interest to our Chinese and Arab colleagues).

Thanks to preparations for the World Cup, the Kaliningrad region has gained vast experience and a huge heritage for further development, which the region has all the conditions and opportunities to make a reality. ■

Part II.

Localisation and investments

Industrial Development Fund: projects support opportunities



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Deputy Director of the Industrial Development Fund since April 2015.

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Professional career began in the procurement department of Procter and Gamble.

From 2010 to 2014, worked in the Ministry of Economic Development of the Russian Federation. In 2014, received an appointment to the Ministry of Industry and Trade of the Russian Federation.

Has been awarded a Letter of Acknowledgment of the Ministry of Economic Development and of the Minister of Industry and Trade. Is part of the federal executive staff pool.

ing comprehensive integration of digital technologies and promoting an export-oriented economy. Implementation of these focus areas requires favourable investment climate in the country and a stable legal environment – the two components needed to attract financial, technological and human resources.

Industrial Development Fund (the Fund, IDF), in turn, takes part in the execution of these tasks by offering a broad range of financial and non-financial support measures to industrial investors, which often include initiators that implement their projects in close cooperation with foreign partners. The Fund concurrently adapts to modern strategic trends by implementing new, effective financing facilities, including ones developed in accordance with the above national priorities.

IDF preferential loans

IDF lending activities enjoy high demand due to the high cost of bank lending in Russia. Despite the Central Bank (CB) key rate reducing by more than half since late 2014 to 7.5%, the Fund's proposal still remains attractive to investors with its basic rate of 5%. A rate of 1% offered for a few IDF products is of particular interest. For other programmes, the rate may be reduced to 3% or even 1% p.a. subject to certain conditions, for example, the applicant's bank guarantee to secure a loan or purchasing of Russian made manufacturing equipment. It should be noted that

amendments to Fund standards have been recently prepared to envisage additional preferences for export-oriented projects with more than 50% of product imports to external markets (1% p.a.).

As of October 2018, the Fund financed 291 projects in various manufacturing industries totalling 68,5 billion roubles. Medium-sized businesses are the main IDF clients, although the borrower's portfolio includes both large and small businesses and even individual entrepreneurs.

IDF offers various financing programme options to production businesses tailored to a broad range of investor needs. These programmes may be divided into several categories:

- Flagship programmes targeted at most of the audience: **"Development Projects"** – targeted at import substitution and production of competitive products; **"Lease"** – allows investors to finance part of a down payment for processing equipment purchase.
- Special-purpose programmes that offer the most preferential terms for top-priority projects for the state in terms of industry-specific and strategic priorities: **"Machine Tool Industry"** – targeted at the manufacture of localised production goods, equipment and machinery; **"Defence Conversion"** – fosters production of high-

Recently, as part of May presidential decrees, the Russian Government has faced ambitious goals, including making Russia one of world's largest economies, accelerating technological development, foster-



tech civilian industry products by military-industrial complex (MIC) enterprises; **“Components”** – intended to create and cooperate local supply chains.

- **“Drug Labelling”** programme is a special-purpose financial product intended to solve a particular task – allow pharmaceutical companies to install special-purpose equipment for product codification for its further tracing in the system for monitor drug flow from the manufacturer to the end consumer within the statutory timelines.
- Programmes to implement May presidential decrees: as part of implementation of the **“Digital Economy of the Russian Federation”** top-priority national project, the Fund has recently launched the new programme titled **“Industry Digitalisation”** that will help finance projects implemented to enhance the level of enterprise automation and digitalisation. IDF has also developed the **“Increase in Labour**

Medium-sized businesses are the main IDF clients, although the borrower’s portfolio includes both large and small businesses and even individual entrepreneurs.

Productivity” programme, which will help enterprises raise funds to implement advanced solutions to foster increased labour productivity.

RIDF regional network

The IDF operation model has proven successful, so the regional chain of industry development funds is currently in active development.

The Fund conducts regular methodological and analytical coordination of Russian constituent entities when creating and developing regional in-

dustry development funds (RIDF) with support tools targeted at small and medium businesses. Regional funds are set up by local authorities. Currently, there are more than 50 regional funds operating according to IDF standards.

By making an agreement with the federal IDF, regional funds are able to jointly finance projects at a ratio of 70% (federal funds) to 30% (regional funds). Requirements for shared loans are less strict in terms of the overall project budget and amount of borrowed funds. Coop-

eration with IDF makes it possible to finance many projects by attracting funds from the federal centre even with restricted capital assets of a regional fund. Presently, “**Development Projects**” and “**Components**” programmes of the Fund offer joint financing. 22 projects have

submission. Prior to the interagency commission’s meeting, IDF provides the Ministry of Industry and Trade of the Russian Federation with a conclusion based on document review results and its position concerning SPIC feasibility with regard to a project under study.

IDF provides comprehensive consulting support at all SPIC stages and helps investors structure their projects and prepare documents for official submission.

already been financed under the joint federal-regional loans programmes.

RIDFs also develop lending programmes on their own terms, which may be of particular interest to small businesses and representatives of industries outside of the jurisdiction of the Ministry of Industry and Trade of the Russian Federation, which are thus beyond the scope of support of the federal Fund.

Fund: SPIC operator

IDF also operates special investment contracts (SPIC) – another tool to attract private funds (including foreign capital) to the real sector. As part of SPIC, parties assume mutual commitments: the investor – to set up or modernise production; the Russian Federation and constituent entities – to guarantee a stable tax and regulatory environment and provide support.

IDF provides comprehensive consulting support at all SPIC stages and helps investors structure their projects and prepare documents for official

SPICs were mainly targeted at import substitution and production localisation. After the instrument was launched in 2015, 25 investment contracts in various industries have been signed with an investment amount over RUB 265 billion. The leading industries are pharmaceuticals, machine tool manufacturing and automobile manufacturing. International companies opt for SPICs as a way to fix the terms of their business in Russia. 17 out of 25 contracts have been signed by companies with participation of foreign capital, including such prominent global market players as Mercedes-Benz, Claas, AstraZeneca, and DMG MORI AG.

The mechanism and key criteria for investors are being currently upgraded. It is assumed that as part of the revised instrument format, the project support decision will favour the investors that implement modern production techniques, extend their production localisation level and conduct R&D. Another essential advantage of a project will be the export of technology-savvy products and integration with foreign supply chains.

Fund: operator of the mechanism for paying interest on loans

The mechanism for paying interest on loans is one of the most sought-after instruments to support industrial investors. It decreases the cost of borrowed funds and increases profitability and payback of new production sites.

After the mechanism’s launch, more than 100 projects have obtained support totalling RUB 9.7 billion. More than 150 projects are being implemented and over 23,000 jobs will be created thanks to state support.

In 2018, IDF has taken a very active part in restarting the support mechanism for industrial enterprises that implement new comprehensive investment projects with increased loan funds in 2017-2019. Submission of electronic applications for short-listing as comprehensive investment projects is envisaged. In addition, amendments imply the possibility of compensating for part of coupon yield payments under the bonds issued in 2017-2019 as part of implementation of comprehensive investment projects in top-priority focus areas of civilian industries.

IDF consultation centre

IDF has a consultation centre (CC), a “one-stop shop” for industrial enterprises willing to gain insight into the numerous peculiarities of state support programmes.

CC specialists provide manufacturers with detailed information about IDF’s own concessional debt financing programmes and help them assess the borrower’s project eligibil-



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Инновации

В GSK работают тысячи ученых. Мы постоянно инвестируем в научные и технологические разработки для того, чтобы разрабатывать и делать доступными врачам и пациентам инновационные лекарства и вакцины.

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The project support decision will favour the investors that implement modern production techniques, extend their production localisation level and conduct R&D.

ity for a particular IDF programme. CC employees also hold consultations using Navigator of the State Industrial Information System that includes all industrial state support measures.

State Industrial Information System

The Fund is developing the State Industrial Information System

(SIIS) by order of the Ministry of Industry and Trade of the Russian Federation. A set of services that considers the requirements of all user levels is being generated in the integrated information space. We will briefly introduce the most popular services.

Support Measures Navigator contains information about the federal

and regional incentives available to industrial enterprises. Each enterprise may choose the measures tailored to its needs in line with preset criteria. In order to keep up with regulatory changes, investors may subscribe to information updates for "selected measures". Some support measures (for example, government resolutions No. 3 and No. 1312) may not only be reviewed, but also applied for electronically.

Support Measures Navigator currently includes more than 900 measures, most of which are under the jurisdiction of constituent entities of the Russian Federation. Detailed comments on each instrument may be obtained from the Fund's CC.

If a project that needs additional financing does not meet the criteria of available support instruments, the investor may use the “Initiative Projects” service, which makes it possible to publish project details to seek private support from development institutions or other investors.

Users may also use ongoing purchase monitoring services. An enterprise may look for purchases at an aggregator platform according to its economic activity or output product, and also analyse suppliers and customers.

The “Industry Atlas” service is an essential element of the SIIS integrated information space. It aggregates information on industrial products manufactured by enterprises, production sites, technology and production capacities.

“Industry Atlas” uses the data collected to present a comprehensive view of the state of Russian industry and elaborate well-founded strategies of local and industrial development, define focus areas for upgrading industrial and regional support measures with regard to actual industrial and regional clustering, and provide enterprises with an opportunity to promote their products on domestic and foreign markets.

In addition, SIIS provides an e-trading platform that enterprises may use to both post information about their products and find suppliers.

Plans for the future

As part of its activities, IDF maintains continuous interaction with all key Russian development institutions and foreign business associations (Association of European Businesses, Rus-

sian-German Chamber of Commerce, Korea Trade-Investment Promotion Agency, United States Chamber of Commerce, Franco-Russian Chamber of Commerce and Industry, General Confederation of Italian Industry, etc.), takes part in the country’s largest investment and industrial activities and regularly delivers reports at international conferences.

IDF actively cooperates with such large Russian public organisations as the Russian Union of Industrialists and Entrepreneurs, Business Russia, the Chamber of Commerce and Industry of the Russian Federation, and OPORA RUSSIA.

IDF maintains continuous interaction with all key Russian development institutions and foreign business associations, actively cooperates with public organisations.

Apart from state support measures that may apply to investors, the Fund also exchanges with its contractors information about peculiarities of Russian law for production set-up in areas with a special legal and tax status. IDF also provides assistance to promote cooperation between business representatives and federal and regional executive bodies. All the above legal and practical aspects are based on the Fund’s expertise and are reflected in regular editions of the Foreign Investor Guide published in cooperation with German law firm Beiten Burkhardt.

To develop this focus area, IDF also intends to provide comprehensive sup-

port to manufacturers looking for potential raw material and component suppliers and buyers in Russia.

Furthermore, the Fund plans to provide active assistance to exporters. The Ministry of Industry and Trade of the Russian Federation and IDF are currently developing a new subsidiary programme that will help local manufacturers not only create competitive products, but also secure their presence on foreign markets. The Fund’s new lines of activities directly correlate to the definition of objectives by the Russian Government as part of the above May decrees and support its willingness

to cooperate with businesses and provide assistance in establishing effective cooperation with the state to handle industry-specific and strategic tasks.

In conclusion, it should be said that despite the last few years, which have seen a challenging economic and political situation, the Russian Government has managed to elaborate and establish a comprehensive working mechanism to support a favourable investment climate in industries. It primarily concerns the instruments envisaged by the law “On industrial policy” available to any corporate Russian tax resident willing to establish two-way dialogue with the state to ensure the balance of interests of both parties. ■

Localisation and import substitution: what foreign producers need to know



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She has a degree in law from Humboldt University, Berlin, Germany, with a specialisation in contract law.

After her studies, Irina has worked for many years in different international law and consulting companies, consulting international clients mainly in localisation issues, contract law, migration law, labour law and cross-border legal issues.



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He graduated with a degree in business administration and economics from Berne University, Switzerland, specialising in financial management, controlling and accounting. Andreas also passed level 2 of the CFA exam.

Andreas held positions as controller, project manager and CFO at Swiss Krono Group plants in Russia and Ukraine. After that, he worked as a business unit finance manager at HP Switzerland. From 2008-2017, he managed an international consulting company in Russia, supporting foreign businesses in finance, legal, tax, HR, IT, and accounting.

Since 2016, Andreas has been Chairman of the AEB North-Western Regional Committee.

rate of the Russian rouble, owing to ever increasing oil prices and inflows of capital. It would just be easier, safer and cheaper to import than to produce in Russia. This underinvestment has led to an over-dependence on natural resources while the industrial base has suffered and become outdated. For many years, this was considered a problem that has not been approached seriously (with certain exceptions).

In the face of increasing tensions between the West and Russia in 2014 and subsequent sanctions and counter-sanctions, the Russian government started a massive programme to replace imports in pre-defined industries with locally produced goods. Meanwhile, the focus would turn from import substitution to export. A law on industrial policy was created, outlining certain principles to build up a competitive industrial base. More laws have been introduced and many government decrees have been issued.

The idea would be to offer investment incentives and give clear preferences, or even exclusivity, to locally produced goods over foreign goods in state tenders and procurement of state-owned companies. The definition of goods made in Russia have since been determined for many industries and goods, with ever-tightening requirements

Introduction

Since the end of the Soviet Union, there has been a lack of investment into industrial capacities in Russia.

This was the case due to the lack of certainty about the outcome of investments as well as a constant increase in the real effective exchange



each year, necessitating more and more local content, value added, manufacturing processes, and the transfer of know-how.

Lately, there have been new initiatives, such as state support for the export of goods, with the Russian Export Centre to offer support in certifying products for foreign markets or in marketing the “Made in Russia” brand. Also, there have been signs that would indicate that closing off of the Russian markets would not last forever. The new Automotive Strategy 2025 contains a plan to strive for integration into international value chains, which, consequently, would require an opening of the market. Also, the Russian President Vladimir

Putin publicly stated this summer that the localisation requirements would be only temporary measures. However, the general expectation is that the measures and legislation are, most likely, going to be in place for a long time.

Restrictions

Exclusion

In some industries, such as pharmacy, medical technology or the automotive industry, there are certain goods which can be purchased only if they are produced in Russia (or the Eurasian Economic Union). For other categories of goods, there are opportunities to purchase foreign goods as long as there are at least two drugs produced in Russia that are foreseen as treatment

against the same illnesses (but not necessarily with the same effectiveness). This is called the third odd one out rule. The Russian government has a list of drugs considered “essential for life”. Those drugs can be purchased only if they are manufactured in Russia. Any foreign drugs foreseen for the same treatment/against the same illnesses will be banned from procurement/tenders as soon as at least two local producers are available.

As an example, drugs listed by the Russian government as *essential* can be purchased only if they are manufactured in Russia as soon as there are at least two local producers available. Any foreign drugs foreseen for the treatment of the same illnesses will be banned from procurement/tenders.

Price discrimination

When no exclusion rules apply, price discrimination rules usually apply instead. Goods made in Russia enjoy a 15% price advantage in tenders. That is, if a foreign good and a local good are offered, the Russian product is al-

A law on industrial policy was created, outlining certain principles to build up a competitive industrial base. Many government decrees have also been issued.

ways regarded as if it was 15% cheaper than it actually is. If the Russian good wins, the bidder receives 100% of the offered price. If a foreign-made good wins in a tender, there will be a 15% price deduction from the offered price. This rule means a price discrimination of >32%, combining the two effects.

Definition of place of origin

In a number of decrees and amendments to decrees, the Russian government has set rules on what constitutes a good made in Russia. Apart from some additional, industry-specific documents, the main guideline is Government Resolution 719 (hereinafter, Res. 719), which was introduced in 2015. Several additions have been made since then. The decree gives detailed criteria for many goods and groups of goods. The main factors to be considered are:

- tax residency in Russia or the Eurasian Economic Union (EAEU);
- performance of defined production steps in Russia or the EAEU (in certain cases, only Russia!);
- rights to relevant technical documentation and design;
- service centre in the EAEU;
- maximum value of imported parts used in production.

For each good and group of goods listed in Res. 719, some or all of these factors are applied. When it comes to production steps to be applied or the ad valorem criteria, the rules become stricter every year or every other year. For instance, there may be a maximum value of imported parts of 40% for 2018, 30% for 2019, and 20% for 2020.

For goods without specific criteria in Res. 719 or industry-specific resolutions, a CIS agreement from 2008 applies. However, this document was

not created for such use. Moreover, it is applied less often as the number of goods without specific localisation criteria are decreasing.

Example: passenger lifts

To be considered made in Russia, there should be a Russian/Eurasian legal entity and the right to use production secrets/documentations for manufacturing for 5 years.

To be considered made in Russia, there should be a Russian/Eurasian legal entity and the right to use production secrets/documentations for manufacturing for five years.

In 2016, there was a maximum value of imported parts in the overall material usage of 30% accepted, in 2017 it was 20%, and in 2018 only 10%.

Additionally, the following parts must be manufactured in Russia or the Eurasian Economic Union:

- cabin;
- operating station;
- doors;
- winch;
- gearing/transmission;
- counterweight.

Confirmation of the place of origin

Documents confirming compliance with localisation requirements are usually an inspection certificate and a so-called ST-1 certificate. These documents are issued for a one-year period by the Chamber of Industry and Trade (CIT) upon providing the necessary confirmation documents

and an inspection by a delegation of CIT experts. In some cases, additional documents may be necessary.

Expert delegations from the CIT may visit yearly to extend the confirmation documents. They may also visit upon complaints by competitors for non-compliance. In the past, expert commissions were often sent by local CITs with limited technical knowledge.

In some cases, the experts would not notice that some processes are not performed according to the law. However, there is a tendency to have more expert commissions sent for inspection by the federal CIT, with highly-skilled experts that cannot easily be fooled.

Special investment contracts (SPIC)

A special investment contract (SPIC) is an investment agreement between an investor and the Russian government. The investor is obliged to invest a certain amount into new manufacturing capacities or into upgrading the existing capacity. In turn, the investor is offered investment benefits, such as tax benefits, subsidies, extension of the time to reach localisation requirements set out by the respective laws, or relief from certain criteria. That is, the contract can, practically speaking, offer a grace period with immediate certification of local production.

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The minimum project investment shall be 750 million roubles (this limit may be raised to 1 billion roubles). The specific terms of the contract can be negotiated with the government based on a business plan. Once there is a decision made on the realisation of a SPIC, there shall be regular performance reviews on the project's status. As an investor, it is important to keep investment promises. Otherwise there can be a request for amendment in the SPIC or the contract can be terminated by the government.

Who should localise?

For whom it makes sense to localise very much depends on the industry. For companies only somehow or not affected by the localisation requirements – directly or indirectly – there may still be informal pressure to localise, the aim to have a better image as a Russian producer or cost advantages from local production. In this case, the decision will be based on purely eco-

nomical factors rather than pressure. As for economic factors, one should be careful about the temptingly low rouble rates that have boosted investment attractiveness. The positive effect may vanish quickly in case of a massive increase in oil prices. The rouble already seems to be considerably undervalued at the current level of oil prices. This is partly due to measures by the Ministry of Finance to keep the exchange rates low. Another factor weighing on the rouble are the latest sanctions by the US and the current generally negative sentiment on emerging markets. This assumes an end to the current sanctions will massively boost the rouble. Things being as they are, the financial models for economic soundness should still yield positive net cash flows in case of 15%-25% strengthening of the rouble or, alternatively, with reasonably high discount rates built in.

Companies selling a considerable part to the state or municipalities or to state-

controlled organisations and companies may have to make a decision to localise and keep the market or not to localise and lose the state part of the market. In industries affected by the restrictions and which sell a large part or in full to the state, it may even mean a retreat from the Russian market without localising. As a matter of course, the localisation measures are very restrictive and may not make sense in every industry. In some cases, the stipulated localisation steps may be unrealistic. In others, the market is simply too small to justify local production. A contract manufacturing agreement could be a way out, in which the transfer of know-how to a partner is a precondition.

Be aware that even when having a purely private client base you might still be affected by them indirectly in case your clients or their clients sell a large part or in full to the state. In such a situation, there can be considerable pressure on their suppliers and sub-suppliers to also follow localisation rules, i.e. on you. Otherwise, your clients or their clients could fail to comply with their localisation requirements for local content.

Finally, there are companies affected by localisation restrictions that bypass them by selling to distribution partners that, in some way or another, manage to have the goods declared as made in Russia. However, this is not a recommended business model. Competitors carefully watch the market, and it is a matter of time until such business practices are detected, denounced and stopped.

In the end, it is an individual decision for each company whether or not to have local manufacturing, weighing the advantages and disadvantages carefully. ■

A new era for localisation in Russia



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Tatiana is a Director in the Deloitte CIS Automotive group. For more than 13 years, she has been responsible for advising companies in the automotive market.

Tatiana is a part of cross-functional automotive team leading projects for various automotive clients.

In particular, Tatiana led the provision of Transfer pricing services to several international and Russian automotive clients and participated in a project for the implementation of DMS systems, change of business model and supply chain optimisation. Tatiana has also led a number of cost reduction projects for automotive companies and dealers.

Tatiana has a degree with honours from Finance Academy. She is also a member of the British Association of Certified Accountants (ACCA).

More than 6 years ago, starting 22 August 2012, Russia became a member of the World Trade Organisation (WTO) and, in accordance with the

obligations Russia assumed toward the WTO, the transition period for the application of the "industrial assembly" regime expired on 1 July 2018. This essentially means that, starting 1 July 2018, the rates of import customs duties on goods classified by the HS codes "for the industrial assembly of motor vehicles of headings 8701-8705, their units and assemblies" must be brought into line with the common rates of the Unified Customs Tariff of the Eurasian Economic Union (UCT of the EEU).

At the same time, the majority of agreements between automotive manufacturers (hereinafter, "the OEMs"), the producers of components for the automotive industry

The Russian state contributed over 500 billion roubles to state support programmes, making the automotive industry one of the key industries for support.

(hereinafter, "the OESs") and the Russian state establishing the status of industrial assembly (hereinafter, "the 166/566 Agreements") end in 2020.

Thus, a new era for localisation must begin for Russia.

What are the key changes to be faced? Are main stakeholders ready for such changes? Where are the key challenges in the relationship between the state and investors?

These are the questions of greatest interest to the market and the issues for discussion in the current article.

Historical background

The Russian automotive industry has historically been backed by key international automotive groups.

Since 2005, car manufacturers have invested more than 500 billion roubles in the automotive area and created more than 25,000 new jobs. More than 60% of OEMs achieved

localisation of more than 50%, while for some of OEMs and OESs localisation was struggling to reach 30-40%.

The Russian state also contributed more than 500 billion roubles to state support programmes, making the automotive industry one of the key indus-

tries for support. The key part relates to so-called “compensation of scrap duty”.

Scrap duty, introduced at the end of 2012, is paid by importers and producers of vehicles in Russia. Simultaneously, the Russian state introduced subsidies for compensation of several types of production costs (salary, electricity, and others) that practically compensated the negative financial impact from the payment of scrap duty by automotive companies with localised production in Russia.

At the same time, local consumption of new cars is lower than existing production capacities, which makes export one of the key focus areas of the Russian state.

Thus, the new requirements could be summarised in the following key principles:

- further localisation of components to 60-70%;
- localisation of R&D and innovative technologies;

bringing the import customs duty for goods imported under the HS codes “for industrial assembly” into line with Russia’s obligations to the WTO, i.e. to increase import customs duty rates both for OEMs and OESs that benefited from decreased rates under the 166/566 Agreements.

There are also plans to amend Regulation 719 “On confirmation of Russia-made products” and, in particular, to significantly increase the list of technological operations to prove the Russia-made status of a Russian automotive manufacturer.

The Russian state is considering the introduction of subsidies to equalise the payment of increased customs duty rates. All the above together is recognised as the so-called “new industrial assembly” regime.

The subsidies to compensate scrap duty are to be extended; however, some OEMs may not have the opportunity to receive such compensation, as the criteria for applicants are to be expanded.

The Russian state is actively promoting the mechanism of special investment contracts (SPICs) that provides a simplified way to receive the status of a Russian manufacturer, but requires the additional investment of at least 750 million roubles.

In summary, investors in the Russian automotive industry are now facing a complicated choice to invest and stay on the “list of Russian manufacturers” benefiting from state support programmes or to stop receiving compensation of scrap duties, equating them with pure importers. Such changes weigh heavily on companies that have invested in Russia in the past.

One could describe the Russian state’s approach for transition to the new era of industrial assembly as a classic “carrot-and-stick policy”.

Correspondingly, the Russian state became a very important stakeholder in the automotive industry. The key OEMs localised in Russia based their business and financial models on the understanding that special conditions related to the compensation of scrap duty and other incentives would remain for at least another 7-10 years.

However, the Russian state clearly stated its agenda for the future in the 2025 Strategy, saying that the new era for localisation should start with expanded requirements for investors to be treated as localised manufacturers in Russia.

The 2025 Strategy complains that a significant part of added value is not localised in Russia. This is mainly because R&D and the material part of components are not localised.

- development of exports (estimated at 9-11% in 2020 and to 13-15% in 2025).

All of the above require significant additional investments from automotive companies in Russia.

The producers of automotive components are also expecting similar changes in the current regime; however, the outcome of such a change is not clear.

What are the key changes to be faced?

One could describe the Russian state’s approach for transition to the new era of industrial assembly as a classic “carrot-and-stick policy”.

In the near future, there are plans to amend the legislation regulating the “industrial assembly” regime,



Are the main stakeholders ready for such changes?

It is certainly the case that OEMs in Russia are not immediately ready for the changes in Regulation 719 and the expanded list of technological operations. Moreover, the potential volume of investments to meet the expanded criteria is much higher than expected for SPICs.

International investors have already invested significant amounts (e.g. in 2015, VW completed construction of an engine plant in which it invested over 250 million euros) that were not recovered by 2018 due to the slow recovery from the crisis.

At the same time, the new localisation regime measures additional and significant investment either by meet-

ing the criteria of the expanded list of technological operations under the amended Regulation 719 or by commitment to conclude a SPIC.

In a situation with a complex political and economic environment, the decision on further investment in the Russian automotive industry is a tough sell.

During 2017 and now, the Ministry of Industry and Trade clearly articulates that SPICs could be considered as practical extension of the 166/566 Agreements. In a press conference, Denis Manturov, Minister of Industry and Trade, stated that no other mechanism besides SPICs was being planned or considered.

International investors have invested significant amounts that were not recovered by 2018 due to the slow recovery from the crisis.

Starting from the end of 2017, the majority of localised manufacturers of vehicles in Russia have SPICs under consideration. One of the drivers was an opportunity to negotiate each specific business case and to receive the status of a Russian manufacturer in a simplified way. In addition, an international investor receives tax incentives like 0% profit tax and property tax.

Provided that the majority of the applicants finish SPIC negotiation process, the automotive industry may become a leader in the number of SPICs signed.

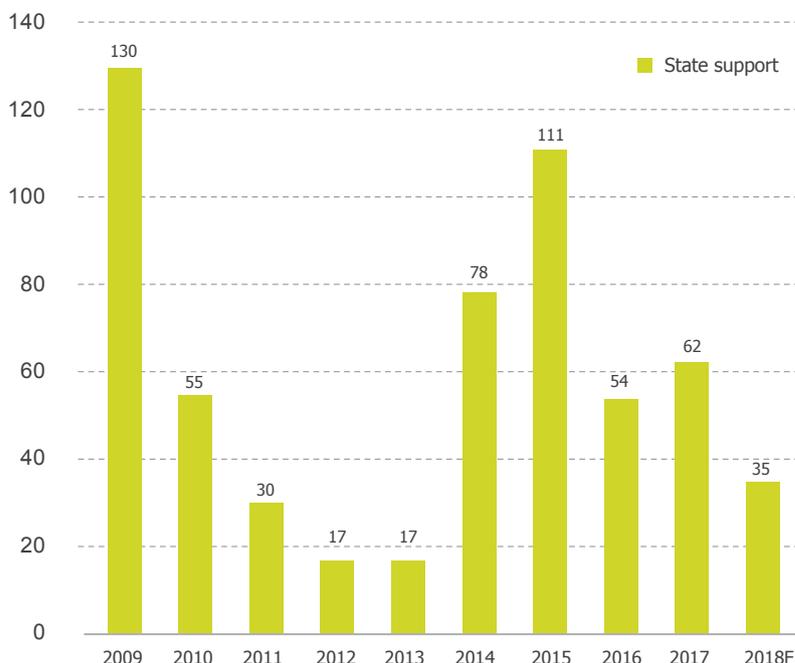
What are the key challenges in the relationship between the state and investors?

Meanwhile, the commitment of the Russian state to continue the support of the automotive industry on the horizon of next 10 years, the duration of a standard SPIC in the automotive industry, is not guaranteed.

The budget for subsidies to OEMs is approved annually and, based on representations from the Ministry of Industry and Trade, there are plans to decrease it. For example, the budget for 2018 is to be decreased in comparison to 2017 from 62 billion roubles to 35 billion roubles.

The requirements for investment in localisation, R&D and export bring extreme challenges for localised manufacturers of components.

► Volumes of state support of automotive industry, RUB bln.



In view of the fact that the subsidies are one of the key factors supporting the localisation business case versus the importer business model, the further decrease of state support may negatively affect the financial attractiveness of localisation in Russia.

In the latter case, we may observe that the new era of localisation has resulted for some investors in the termination of production in Russia.

State support is not the only expectation between the Russian state and the OEMs.

One important challenge is to expand localisation in Russia by establishing a localised chain of suppliers that meet the quality and other criteria of localised OEMs.

Historically, the Russian state paid less attention to localised suppliers that could pay decreased rates of import customs duties on goods classified "for industrial assembly" under the 566 Agreements but were not recipients of other types of state support measures.

In view of the new era of localisation, the requirements for further investment in localisation, R&D and export bring extreme challenges for localised manufacturers of components. The market of OESs suffered huge losses during the crisis of 2015-2016 that have not yet been recovered. In average estimates, the capacity of localised production of automotive

components was only 40-50% loaded during last five years.

For example, one month ago Fujikura, a supplier of cable for Volkswagen, decided to discontinue its production in Chuvashia after three years of operations in Russia.

The market requires the joint efforts of the Russian state, OEMs and OESs to transition the producers of components to the new localisation regime.

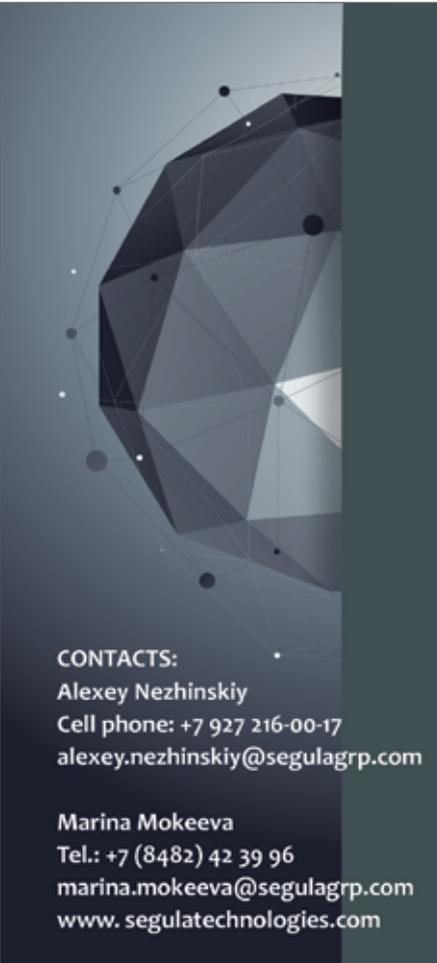
The other requirement for new localisation is the development of R&D and innovative technologies in Russia. This is a rather new requirement for inter-

national investors that, apart from the investment, may lead to the necessity of registering the developed innovations in Russia. This brings additional legal and commercial risks for OEMs that should be mitigated by the consistent and continuous efforts of the Russian state.

The development of exports is also a challenging task for international OEMs and OESs. The markets of the Eurasian Economic Union are limited, while exports to other countries bring additional costs for customs duties and other entry costs. As a result, the majority of export business cases are not competitive and have limited potential for growth.

Similar to R&D requirements, the development of exports will require joint efforts from investors and the Russian state. The latter has announced the negotiation of free trade agreements with Vietnam, Egypt and Iran. However, the list should be expanded further.

In summary, the new era of localisation should soon start in Russia. Whether such change brings the profitability and sustainable growth to investors in the automotive industry and the dramatic change in the industry expected by the Russian state is still uncertain. In any case, the coming changes will effect each and every company working in the automotive market. ■





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Реклама

How to reduce the cost of production localisation in Russia

Five main barriers for foreign industrial investors and ways to overcome them. Timur Shagivaleev, CEO of Alabuga special economic zone, discusses the main risks for foreign industrial investors in Russia and offers ways to reduce them.



TIMUR SHAGIVALEEV
CEO, Alabuga special economic zone

Timur Shagivaleev is the CEO of Alabuga special economic zone since 2011. He came to his current position after three years as Chairman of the Board of Directors of SEZ Alabuga.

Previously he was a counselor of the Prime Minister of the Republic of Tatarstan on external economic activity, corporate secretary of the Tatarstan-Korean Petrochemical Company, and head of the Regional Administration of the Federal Agency on Management of Special Economic Zones in the Republic of Tatarstan.

Today, despite sanctions and a difficult global economic situation, Russia remains an attractive and desirable platform for foreign investors. Our country is a large market, and the prices for raw materials and energy resources are often lower than in other countries.

However, the production localisation cost in our country has inevitably increased. According to our experts' assessment, after the announcement of sanctions, the country's risk premium increased to 10-15% compared to 5% in the pre-crisis period. Investors who are ready to invest in projects in Russia should have real solutions for overcoming all types of barriers to starting localisation that they may potentially encounter.

Currency risks

The most obvious risk when increasing the investment base in Russia is the currency risk. Devaluation of the local currency (rouble) leads to an increased payback period for projects credited in dollars, and also automatically increases the cost of production using imported components and raw materials.

But, at the same time, localisation of production in Russia opens up opportunities for investors to access cheap rouble loans that can reduce the level of currency risk. There are various support measures offered by the government available for localised production in the country. For example, there are concessional loans available from the Industrial Development Fund.

Placing production at developed industrial sites with modern infrastructure and in special economic zones (SEZ) can develop an industry cluster around the new enterprise. A large anchor manufacturer attracts Russian suppliers of raw materials and components for its production. In the mid-term, it makes it possible to reduce the level of currency risk by purchasing raw materials in roubles and increasing the level of localisation.

Alabuga special economic zone has such an "anchor" investor represented by the Ford Sollers automotive plant, which produces SUVs and light commercial vehicles. In launching local automobile manufacturing, the company has learned how to increase its localisation volume and, as a result, stamping production from the Turkish company Coskunuz emerged in the special economic zone. Later, a service metal centre for the production of metal billets was built. By saving on raw materials and reducing logistics costs, Ford Sollers reduced the cost of automotive components and now delivers them not only to its Russian enterprises, but also to Ford plants in Europe.

Following Ford Sollers, another Ford partner and a special vehicles manu-

facturer, ST-Nizhegorodets, became Alabuga resident. A fairly small production was located on the ready-made leased areas of the Synergy industrial park. Thus, the company reduced capital costs and significantly accelerated the implementation of its project.

Market risk

Despite the fact that in recent years the economy and demand in Russia remains relatively stable, some fluctuations in the future are inevitable. We remember how after devaluation of the rouble, the demand for some types of goods reduced by half. In such situations, market fluctuations are less threatening to the stability of companies that purchase raw materials and components in the rouble zone and, at the same time, are able to sell the

finished products not only inside the country, but also abroad.

A striking example in Alabuga is the Turkish Kastamonu plant, which produces flooring and wood panels. The main components of the final cost of wood panels are electricity, gas, and wood. The cost of gas in Turkey before rouble devaluation was 3 times higher than in Russia, and now it is 5 times higher. The cost of wood was 2 times higher, and now it is 3 times more expensive than in Russia. With such data, localisation of production within the country was absolutely justified. The company launched the plant in 2014, later doubled production capacity, and today exports two-thirds of its products. The company purchases raw materials and

resources in roubles, and sells the finished products in another currency. At the current rate, it is extremely profitable.

The Russian company Alabuga-Fiber, a manufacturer of carbon fiber, was initially created with the expectation of export deliveries. The annual production volume of such a modern and globally in-demand product exceeds 1,500 tons, and the domestic Russian market is not yet able to absorb this volume completely.

Lack of qualified personnel

Companies that host their production plants in Russia often face a shortage of qualified workers. The low-cost labour force in Russia does not com-



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compensate for the lack of skills. Today companies are gradually solving the personnel shortage problem, fighting in highly competitive conditions for the best specialists. Nevertheless, the issue of staff development requires long-term work. It is necessary to implement “long” strategies for advanced training and look for territories and partners that are already doing this work and can provide new production with prepared, highly qualified personnel.

The SEZ Alabuga understands its residents’ need for highly qualified personnel. Today, the factories need specialists in electrical engineering, mechatronics, chemistry, and automated production management systems. These specialists are in demand at any modern production facility both in Russia and abroad. To meet the need of our residents for such employees, in the next 5 years we will implement a programme to teach children

engineering skills, starting with the school bench. Our educational strategy is enormous, long, large-scale work. The goal is to provide our residents with ready personnel for the next 20 years and create in Tatarstan a federal centre of the highest competence for global production.

High capital costs

Taking into account the increased country premium for risk, companies are willing to minimise their capital costs by shifting them to operating costs. A fully prepared infrastructure and partnership mechanisms for sharing capital costs can reduce the investor’s risk. This practice is beginning to be implemented in certain regions and sites in Russia.

The SEZ Alabuga managing company offers a “built-to-suit” mechanism for prospective and long-term projects, where we are constructing a production building for the investor’s needs

and then renting it to them. This greatly reduces the investor’s capital expenditures. For example, last year the SEZ Alabuga constructed a production building for the MMK-Coskunoz plant. As a result, the capex of investors fell to less than half.

Of course, build-to-suit is focused on large and long-term projects, and the developer company evaluates the risks together with its partner. But this is an excellent option for modern industrial companies.

Monetary risks

We know that large foreign investors are interested in dividing monetary risks with the government. Our country has developed an improved mechanism for a special investment contract. It guarantees unchanged tax conditions for investors who have localised production in the Russian Federation. Our analysts studied 10 large industrial projects with a total cost of almost 10 billion USD that could be realised within the Republic of Tatarstan, but cannot due to monetary risks. And we came to the conclusion that at least 10% state participation in the capital of new projects would significantly increase their attractiveness. At the same time, the return on the implementation of these projects will compensate government costs for 5-10 years.

In summary, I want to say that foreign investors in Russia can still successfully implement large-scale industrial projects, as there are many different possibilities for this in our country. It is worth trying to implement most of these opportunities in order to reduce time, money and, ultimately, the risks of production localisation. ■

Part III.

Before you start

Sanctions risks affecting foreign investments in Russia



ETHAN HEINZ

Counsel, Dentons

Ethan has worked in Dentons' Moscow office for twelve years.

Although his principal focus is on M&A and private equity transactions, he also devotes a significant portion of his practice to compliance matters, including in particular the US Foreign Corrupt Practices Act and US, EU and other sanctions against Russia.

Prior to joining Dentons, Ethan was an associate for four years in the New York office of a Magic Circle law firm, and also served for two years as a law clerk to the Hon. Richard W. Goldberg of the US Court of International Trade.

Among the most significant challenges facing foreign investors in Russia in recent years are those posed by the sanctions and restrictive measures implemented by the United States (US), the European Union (EU) and other jurisdictions, as well as the Russian response to them. Although western sanctions and Russian counter-sanctions have acted

as a drag on the Russian economy and foreign direct investment in Russia, most foreign investors find that, with attention to detail and adequate risk management procedures in place, business can still get done. The information below provides an overview of sanctions affecting foreign investment in Russia and includes steps to mitigate risks arising from sanctions.

Sanctions framework

In response to events in Crimea and eastern Ukraine in 2014, both the US and EU imposed a range of broadly similar sanctions targeting persons and entities deemed to be involved in those events, as well as those perceived to be close to the Kremlin or to have particular importance to the Russian economy or the Russian defence sector. Although other jurisdictions, including Canada, Australia, Japan, Norway, and Ukraine, have also implemented sanctions against Russia, for most foreign investors EU and US sanctions are the most relevant, and are thus the focus of this overview.

US and EU sanctions targeting Russia comprise four principal types of measures:

Blocking sanctions: blocking sanctions prohibit all transactions by US or EU persons (as described below) with designated persons (known under US sanctions as "Specially Designated Nationals" or "SDNs"), and require such

persons to block (freeze) the assets of the SDNs. US sanctions even prohibit the receipt of any services from an SDN.

Sectoral sanctions: sectoral sanctions target Russia's state-owned financial institutions, oil companies and certain defence firms, but they do not prohibit all transactions. Instead, they generally prohibit the provision of new financing to, or dealings in new debt securities issued by, such entities with a maturity greater than a specified term (presently 30 days under EU sanctions, and 14 to 60 days under US sanctions, depending on the sanctioned entity), and in many cases dealings in new equity of such sanctioned entities. "New" in this context means financing made or debt or equity issued (or materially amended) after the effective date when such sanctions were introduced. Importantly, all other transactions with sectorally sanctioned entities are permitted, unless restricted by other sanctions provisions.

Technology transfer restrictions: these measures restrict exports to Russia and Russian persons of military and most dual-use technologies, as well as the provision of goods, technology and services relating to projects for the exploration or production of deep-water, Arctic, or shale oil (although US sanctions concerning such "special" oil projects are more comprehensive than their EU analogues).

Crimea: both the US and the EU restrict investment in Crimea and transactions with Crimean entities. The US embargo is almost total in scope, allowing only the sale into Crimea of a small list of goods (such as most pharmaceuticals), technology and services. The EU's embargo is somewhat less extensive; while investments in Crimea and the export of goods from Crimea are prohibited, the schedule of goods that may not be sold into Crimea is lengthy, but not comprehensive (permitting light passenger cars while prohibiting personal computers and refrigerators, for example).

Transactions that "knowingly and intentionally... circumvent" (in the parlance of EU sanctions) or "evade or avoid" (per US sanctions) applicable restrictions are also prohibited. A breach of either EU or US sanctions may result in criminal liability,

Most foreign investors find that, with attention to detail and adequate risk management procedures in place, business can still get done.

including significant fines and substantial terms of imprisonment (for example, up to five years in Germany; six years in the Netherlands; seven years in the UK; and twenty years in the US).

In many cases, licences may be sought to engage in a transaction that would otherwise be prohibited by EU or US sanctions, although there is no guarantee that a licence will be issued. The US and member states of the EU have also issued various licences of general applicability.

Sanctions targets

EU restrictive measures in the form of blocking sanctions apply not only to designated persons, but also to entities directly or indirectly majority-owned or otherwise controlled by a designated person. EU sectoral sanctions apply to non-EU entities that are directly or indirectly majority-owned by a sectorally sanctioned entity, or that otherwise act on behalf of or at the direction of such sectorally sanctioned entity. Under US sanctions, all entities at least 50% indirectly or directly legally or beneficially owned by one or more sanctioned per-



sons are themselves also considered to be subject to equivalent sanctions. Other indicia of control are not taken into account, although US authorities have cautioned that they may give rise to future sanctions designations.

EU and US authorities have frequently coordinated Russian sanctions targeting and there has traditionally been a significant degree of overlap between the sanctions lists of both jurisdictions. However, in April 2018, the US departed from this approach by designating as SDNs various Russian industrial concerns, such as En+, Rusal, GAZ Group, and Renova, which had been widely perceived as mainstream Russian businesses significantly integrated into the world economy, and not mere extensions of the Kremlin. These designations have caused substantial market disruptions, which were only partly mitigated by general licenses allowing various periods of time to wind-down

of such jurisdiction (as well as lawful permanent residents of the US); individuals of whatever nationality physically present within such jurisdiction; and companies and other entities formed under the laws of such jurisdiction. That being said, the prohibitions on evading or avoiding, causing a violation of, or attempting to violate US sanctions are directly applicable to non-US persons outside the US, although US authorities may face practical challenges in asserting personal jurisdiction over such individuals. Nevertheless, US sanctions targeting Russia do differ from certain other US sanctions programmes, such as those against Iran, that are binding on foreign subsidiaries of US companies.

In principle, provided that a given transaction in Russia can be carried out without any nexus to the EU/US – for example, if it does not require any corporate approvals to be given by a

However, this does not mean that the transaction will carry no sanctions-related risk. In particular, under various provisions of the stringent sanctions law commonly known as CAATSA that the US adopted in August 2017, non-US persons can be subject to “secondary sanctions” for engaging in certain transactions. (Importantly, EU sanctions do not contain any analogue to CAATSA’s threat of secondary sanctions.) Of particular note, under section 228 of CAATSA, non-US persons may themselves be designated as an SDN if they engage in or otherwise facilitate a “significant” transaction with a sanctioned person (whether an SDN or a sectorally sanctioned entity), unless a US person could also lawfully engage in the transaction without obtaining a specific license. And under section 231 of CAATSA, both US and non-US persons that engage in a “significant” transaction with a listed entity operating in the Russian defence or intelligence sector – some of which, like their western counterparts, have significant civil operations – may be subject to five or more enumerated measures largely designed to reduce or curtail their access to the US financial system, but which may include an asset freeze.

Official guidance on what may constitute a “significant” transaction states that US officials will consider such factors as the size, frequency and nature of the transaction; management’s awareness and the existence or absence of deceptive practices; whether the transaction involves a blocked person; the impact of the transaction on statutory objectives; and other factors deemed relevant by US authorities. In effect, although de minimis transactions are unlikely give rise to secondary sanctions, the great discretion afforded to the US executive branch means there are no truly safe harbours.

Foreign investors should be sensitive to the use of financial covenants that require compliance with US, EU, and other sanctions.

pre-existing transactions. No less importantly, they underscored the unpredictability of future US sanctions designations.

Risk of secondary sanctions

Generally, EU and US sanctions targeting Russia as described above are binding only on legal entities and individuals within the respective jurisdictions of the EU member states and the US, e.g. citizens or nationals

parent company from such jurisdiction; if no personnel from such jurisdiction (including secondees or directors, for example) will be involved in the transaction; if goods, services, and technology will not be obtained from such jurisdiction for the transaction, and so forth – then in most cases engaging in the transaction will not directly breach EU/US sanctions laws that would otherwise prohibit such transaction if it were entered into by a EU/US person.



For over a year after CAATSA's enactment, the US government refrained from applying secondary sanctions under CAATSA (other than against several Russian persons for cyber activities). However, in September 2018, the US imposed secondary sanctions under section 231 against a Chinese military department and its director, which included not only a prohibition on foreign exchange and other transactions within the US financial system, but also designation as an SDN. Given that these secondary sanctions were imposed in relation to a substantial arms transaction, they may seem less relevant for most foreign businesses in the Russian market. Nevertheless, the risk that the US may be transitioning to a phase of more aggressive im-

plementation of secondary sanctions cannot be ignored.

Aside from the threat of US sectoral sanctions, foreign investors should be sensitive to the widespread use of financial covenants (including in financing agreements with many EU, Asian, and other non-US banks) that effectively require compliance with US, EU, and other sanctions. The risk and adverse consequences of a breach of such covenants may be as great or greater than that of US secondary sanctions.

Increasing US sanctions and dissonance with the EU

EU sanctions policy against Russia has been characterised by stability and

predictability since 2014. Although there have been occasional additions to the list of blocked persons (such as in connection with the diversion of Siemens turbines to Crimea), generally speaking the predominant approach within the EU is to maintain the sanctions status quo, neither lessening nor increasing existing restrictions. This is largely a function of the need for unanimity in adopting sanctions. Individual member states inclined to adopt a more robust sanctions policy towards Russia can, however, engage in more vigorous enforcement of existing sanctions, or make use of other measures (such as the increasing use of Unexplained Wealth Orders in the UK).

The US took its first major step to de-link its Russian sanctions policy from the EU's with the adoption of CAATSA in August 2017, and took a further step in this direction with the April 2018 SDN designations of major Russian industrial concerns. More recently, in August 2018, the US adopted new sanctions (more akin to a limited embargo) against Russia as a result of the use of chemical weapons in Salisbury, England, and more severe sanctions (potentially including measures amounting to a more widespread embargo) are likely to be implemented in late November 2018, based on the requirements of applicable US law.

Moreover, numerous bills have been introduced in the US Congress in 2018 that would impose harsh new sanctions on Russia, either immediately or in the event of future interference in US federal elections. It may be that none of these bills ever becomes law, but this manifestation of anti-Russian sentiment in the US Congress cannot be ignored. Other US political factors are also potentially relevant to the evolution of US sanctions, including the

The predominant approach within the EU is to maintain the sanctions status quo, neither lessening nor increasing existing restrictions.

ongoing special prosecutor's investigation into matters concerning the 2016 US presidential election.

Russian counter-sanctions

EU, US, and other foreign sanctions are not the only sanctions-related sources of risk that foreign investors must consider. The initial Russian government legislative response to western sanctions was largely confined to an import ban on a range of agricultural and food products, in particular fresh meat, fish, poultry & dairy, and produce. More recently the Russian President has been granted very wide discretion to implement diverse retaliatory measures against foreign states, and their companies, that implement sanctions against Russia, although it is anticipated that this will only be used in response to significant new sanctions, and not merely maintenance of the status quo.

Of greatest concern to foreign investors, earlier in 2018, the Russian Duma considered a bill that would impose administrative or criminal liability for complying with sanctions against Russia. This engendered vigorous objections from the Russian and international business community, and as of this writing further consideration of the bill has been deferred, but is likely to resume at some point.

Recommendations for mitigating sanctions risk

Against this sobering backdrop, what steps can foreign investors take to minimise their sanctions risk? Although different investors and transactions have different risk profiles and there is no one-size-fits-all solution, the following measures will often be helpful.

- Routinely screen actual and potential counterparties and transactions for potential sanctions risks. This should not be a purely automated process; while official websites and commercial compliance databases are extremely helpful in such diligence, there is no substitute for a clear-eyed assessment of the risks by an experienced compliance officer. When in doubt, engage legal counsel.
- Understand that Russia is now regarded as a higher-risk jurisdiction, especially by persons with little direct experience here. Foreign banks, insurers, suppliers and other commercial partners may require an extra degree of assurance that, for example, a given funds transfer, project or sales order is lawful. Proactive management will minimize the risk of delays.
- Where appropriate, exclude every nexus between the transaction and the jurisdiction whose sanctions laws would otherwise apply. Under US sanctions laws, this usually requires having a general recusal policy in place, since an ad hoc decision to transfer responsibility for a transaction to a non-US colleague may itself be regarded as unlawful facilitation of the transaction.
- Where relevant, assess the risk of secondary sanctions and take steps to mitigate it. This may include such measures as engaging proactively with appropriate officials from one's own government (e.g. trade officials or commercial attachés), especially if from a jurisdiction friendly to the US; seeking preliminary guidance from US authorities; and/or maintaining a low profile. (However, this should never cross the line into engaging in deceptive practices, which will increase the risk of secondary sanctions.)
- Be prepared for the unexpected, especially the risk of progressively worsening US sanctions. Where possible, incorporate sanctions-related "escape clauses" in contracts, while bearing in mind that these will not always be enforceable under Russian law. To increase the chances of enforceability in Russia (if relevant), it is recommended not to refer exclusively to western sanctions against Russia but rather to all applicable restrictive measures and sanctions, including those under Russian law.*

* The views expressed in the article do not constitute legal advice. Specific advice should always be sought before engaging in any transactions with potential implications under the sanctions laws of any jurisdiction.

Protecting investments: accurate legal compliance with sanctions, anti-money laundering and anti-corruption



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Pietro is an international lawyer with several years of experience who focuses his practice on the retail sector and service industries such as real estate and hospitality, cross-border transactions, blockchain and ICO, fraud, and commercial law.

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Anna has been practicing law for more than 19 years.

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She graduated with distinction from MGIMO and obtained a Ph.D. in Law from MGIMO.

a large number of Russia-based companies have established their own internal Compliance Departments.

Companies should adopt and implement a corporate governance compliance programme (CGCP) that includes, among others, specific compliance with sanctions and anti-money laundering (AML) and corruption laws and regulations. With CGCP we define compliance obligations associated with certain critical aspects of corporate governance in the current global geopolitical and business environment, namely with being a good corporate citizen in Russia and in international business, especially in the financial community. It is recommended that all major Russian companies, as well as international entities operating in Russia, learn and adopt a culture of compliance under the heading of CGCP for the reasons explained below and continuously review their compliance.

Why complying?

Strict legal compliance with AML and corruption legislation is required. Notwithstanding the absence of criminal liability of corporations in Russia, penalties under the Code for Administrative Violations of the Russian Federation may be imposed, such as high mon-

What is compliance?

Compliance means an act of obeying an order, rule, or request. In worldwide practice, compliance departments are created both to identify and minimise

the risks that organisations face and to resolve compliance difficulties when they occur. In the Russian Federation such a term does not have an official legislative interpretation though quite

etary fines and disqualification of top employees. Directors, owners, and top executives of businesses may also face criminal liability, which can include fines, disqualification of up to 5 years, or imprisonment of up to 7 years. From an outside point of view, any AML or corruption non-compliance may also result in criminal liability that can be even more severe than in Russia, as well as result in sanctions against a particular company or particular individual by US and European Union authorities, which may result in huge financial losses.

Compliance with sanctions

More so than ever before, companies operating in Russia must develop and implement Office of Foreign Assets Control (OFAC) sanctions detection and monitoring programmes. Sanctions are instruments intended to create a negative atmosphere as well as business and personal consequences when it comes to investments and the way people do business in general. Specifically, sanctions aim to freeze financial assets which belong to legal entities

ways political in nature, since they are enacted by executive branches (governments) of countries.

In the present context of sanctions against the Russian Federation and other jurisdictions, there is a real element of risk when investing in business activities in Russia that do not comply carefully with the international sanctions' regime, namely engaging in prohibited financial and transactional operations, investments, trading, or other activities, especially with sanctioned persons and entities.

Thus, sanctions do not only carry a psychological impact when hindering potential investors from new activities, but they cause very real risks and negative consequences for those who engage in business with sanctioned entities without assessing and implementing proper conduct. It is therefore necessary to carefully consider precautionary measures in order to set up appropriate sanctions compliance activity and thus create ideal conditions for risk-free transactions that are reliable for investors. Such an ap-

legal perspective, it is very important to identify some of the major players and their powers to enact and implement such measures – OFAC and the European Council.

OFAC, which acts under the US Department of Treasury (executive branch), is the relevant office that publishes and continually updates a list of Specially Designated Nationals and Blocked Persons ("*SDN List*"), as well as a list of Specially Designated Narcotics Traffickers ("*SDNT List*"). Sanctioned person(s) and/or entities placed on the SDN or SDNT Lists, including those placed on the SDN List pursuant to GLOMAG (2016 Global Magnitsky Human Rights Accountability Act), may have their US-based property and interests in property "blocked". Businesses and investors must be aware that their failure to comply with OFAC sanctions *will lead to the "blocking" of wire transfer payments, the loss of international banking privileges, and potential civil and criminal penalties*. There are many other direct consequences and collateral consequences, among others being stopped for secondary inspection and denied entry at immigration and customs entry points into the US, and being placed on US airlines' "no-fly" lists. Sanctions compliance can, however, be put in place by companies by studying their business relationships in order to identify potential risks of OFAC sanctions and their consequences. An appropriate OFAC compliance programme should be implemented to avoid these costly repercussions. It must be stressed that even if an individual or entity is placed on OFAC's SDN list, it is still possible to act legally and seek "*de-listing*". De-listing from the SDN or SDNT Lists, including those placed on the SDN List pursuant to GLOMAG, regularly occurs by filing a timely request for reconsid-

Sanctions cause very real risks and negative consequences for those who engage in business with sanctioned entities without assessing and implementing proper conduct.

and individuals, often affecting at least one of the most personal spheres of freedom – property. Sanctions may be considered as administrative measures with no apparent remedy and are often enacted based on political motives. It can be argued that sanctions are al-

proach is rather important nowadays in the context of international business investments, and business in the Russian jurisdiction is no exception.

In order to have a better understanding of the issue of sanctions from a

eration. There are two ways to appeal OFAC's denial of a reconsideration request: (1) submitting a new administrative reconsideration; (2) initiating a lawsuit under the Administrative Procedure Act ("APA") against OFAC in the US District Court of Appeals for the District of Columbia.

OFAC administers a number of different sanctions programmes not related to a particular jurisdiction. *Thus, it is vital to stress that proper business conduct is not limited to behavior in one jurisdiction, but applies to relations with sanctioned entities and business activities in any other jurisdiction*, as the recent case of Russia's Agrosoyuz Commercial Bank demonstrates. On August 3, the Treasury Department

imposed SDN sanctions on Agrosoyuz Commercial Bank over handling transactions for North Korea in violation of United Nations restrictions.

In the EU, sanctions against other jurisdictions are usually enacted after a vote by the European council, which involves all the heads of states and governments of the 27 member states.

Anti-money laundering compliance

All companies, especially financial institutions, should develop and implement "gold standard" AML in accordance with the internal laws of the company's jurisdiction as well as relevant international treaties and agreements. Effective AML requires the following:

(1) written policies and procedure; (2) compliance; (3) training; and (4) audit. Such a comprehensive AML programme will help companies preserve their important banking relationships and avoid law enforcement scrutiny and investigation which, in case of non-compliance offenses, can result in jail sentences, high monetary fines, and other penalties.

The main relevant act of the Russian Federation to comply with in this field is the Anti-Money Laundering Law (*Federal Law No. 115-FZ on Countering Legalisation [Laundering] of Proceeds from Crime and Financing of Terrorism*) dated August 7, 2001, which is regularly amended (last amendments came into force on July 23, 2018).



There are also plenty of other regulatory acts issued by AML regulators.

The general authority is the Federal Financial Monitoring Service (*Rosfinmonitoring*). It requires individuals trading commodities or on financial markets to provide information upon request, gathers and analyses reports of suspicious transactions, prosecutes violations of AML legislation, and transfers the collected data to the appropriate law enforcement authorities for further investigation and action. Multiple orders of Rosfinmonitoring shall be complied with.

Among other domestic AML regulators are the Government of the Russian Federation, the Bank of Russia, the Ministry of Finance, the Assay Chamber (under the supervision of the Ministry of Finance), the Federal Supervision Service for Communications, Information Technologies and Mass Communications (*Roskomnadzor*), and the Federal Tax Service, which issue various resolutions and orders to comply with. Each of these state bodies have their own specialisation, e.g. the Bank of Russia is responsible for credit organisations, insurance companies, and professional participants in the securities market, while the Assay Chamber is in charge of entities engaged in trade in precious metals, gemstones, and jewelry. In the last 4 years, the Bank of Russia has revoked more than 350 bank licenses (96 in 2016, 51 in 2017, 28 during the first half of 2018) for non-compliance with AML requirements and other violations. Internationally there are many relevant bodies as well.

Corruption compliance

There is much more emphasis throughout the global business com-

munity on suppressing all forms of corruption. Global and Russian companies must develop a general awareness of the perils of paying kickbacks or bribes, and must learn how to avoid dealings with corrupt officials, including with corrupt foreign officials or Politically Exposed Persons (PEPs).

Companies must be aware of the Foreign Corrupt Practices Act, a US federal statute that prohibits US companies, or other companies under US jurisdiction (any foreign company, including a Russian one, can under certain circumstances fall under US jurisdiction), from bribing public officials to obtain a commercial advantage. The US Department of Justice has prioritised FCPA investigations and prosecutions to attack this form of business corruption. Global companies must be made aware of FCPA requirements and must train their employees and senior management accordingly. Companies also must be aware of the Magnitsky Act, which authorises and requires OFAC to list and sanction individuals or entities that are involved in corruption or human rights violations.

The Russian Federation is categorised by the US State Department as a jurisdiction of primary concern with respect to money laundering and financial crimes such as corruption. Official corruption remains a problem at all levels of government and a major source of laundered funds, especially in the judicial system and public procurement. The situation with state corruption is considered one of Russia's vulnerabilities. Thus, measures to counter corruption mostly concern government employees, though B2B corruption is also punishable.

Federal Law No. 273-FZ on Countering Corruption dated December 25, 2008 is the main document to comply with in this field in Russia. Many subsidiary documents were later adopted which mainly place additional requirements on government employees. For example, in 2016 state officials were banned from owning securities or other financial assets located or registered abroad through third parties. Russian law controls both income and expenses of state employees. Since 2018 both state and municipal officials may be dismissed on the grounds of loss of trust. Russian law criminalises active and passive bribery, facilitation payments, gifts, and other material benefits.

The President of the Russian Federation adopted 6 National Plans on Countering Corruption, the most recent one on June 29, 2018 for 2018-2020. Other regulatory bodies in the area are the Government of Russia and the Ministry of Internal Affairs of the Russian Federation.

Introduction of compliance practice with corruption norms has been a programme of the fourth step (started in 2010) of combating AML and corruption at the international level and at the level of particular countries. All companies must understand these significant risks of being involved in corruption schemes and must implement the appropriate anti-corruption policies and procedures. If companies fail to address these issues, they may find themselves under criminal investigation for commercial bribery, sanctions violations, or money laundering, and they will suffer significant reputational harm and financial losses. ■

A positive trend in investment climate and Russian bureaucracy



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Despite the global political turmoil especially expressed in a trade war and continuing sanctions against Russia, business, although somewhat hurt, is continuing to invest or even extending investments in Russia. This might be due to pressure to localise production, but it still seems to show that Euro-

pean companies in particular believe in the Russian market and economy. What needs to be done to set up business in Russia and what troubles might you face?

To be able to conduct business activities in Russia, a foreign person must fulfill the following conditions:

- open a subdivision (representative office or a branch) or establish a subsidiary;
- fulfill all migration formalities and sign employment agreements with employees;
- pay wages to employees, including relevant social insurance payments to the budget of the Russian Federation.

A representative office allows a foreign company to be present in the Russian market, but not to carry out commercial activity, i.e. it is forbidden for a representative office to import, purchase, and sell goods. Compared to a representative office, a branch can perform commercial activity. A representative office or a branch acts in the name of its head office.

A subsidiary company can perform commercial activity in Russia without restrictions. The prevailing legal form of an organisation for conducting commercial activity with foreign investors is a limited liability company. A limited liability company (Russian abbreviation "OOO") is a company with charter

capital divided into shares. The participants are not responsible for the company's liabilities and the risk of losses is limited to their shares in the charter capital.

An employment agreement is grounds for commencement of an employment relationship stipulated by labour law. In accordance with the Labour Code of the Russian Federation, employment relations between an employer and employee should be formalized by executing an employment agreement in writing within three business days from the date of actual employment.

When hiring foreign employees, the Russian legal system offers two main ways to obtain a work permit for a foreign employee: the standard procedure and that for highly qualified specialists (HQS).

When applying for a work permit according to the standard procedure, one should bear in mind the so-called quota principle, i.e. a work permit in Russia is given within the framework of quotas determined for each calendar year by the government of the Russian Federation. The employer must notify state authorities about its plans to employ foreign employees for the next calendar year.

The main criterion for HQS status is the annual salary, which must exceed 2 million roubles (about EUR 25,500) gross per year or 167,000 roubles



The prevailing legal form of an organisation for conducting commercial activity with foreign investors in Russia is a limited liability company.

(about EUR 2,100) gross per month. Criteria such as education, qualifications, and work experience of the foreign employee are evaluated by the employer. In addition, key features of the facilitated migration scheme for highly qualified specialists should be taken into account: no quotas for the work permit; apostilled degree certificates or medical tests are not necessary (and several other features).

There are also certain prescriptions regarding the migration registration of foreigners coming to Russia, including those coming for further work in Russia. According to the newest changes in migration regulations, migration registration at the foreigner's place of stay must now be issued only at the actual residential address of this person (the place regularly used for sleep and rest which, as a rule,

is an accommodation provided by a Russian citizen). Employers will now be allowed to act as a host party only if they provide the foreign specialist with premises to live in (in force since July 8, 2018).

Russian legislation introduced several laws to help establish subsidiaries in Russia.

1. Simplified state registration rules:

- implementation of an electronic interaction system between registration (tax) bodies and so-called "multifunctional centres", which also accept documents for incorporation registration. This will help one navi-

- gate the registration procedure more easily (through a multifunctional centre) without spending additional time (in force since April 29, 2018);
- issuance of all registration documents in electronic form (in force since April 29, 2018, but not actually applied yet by registration bodies, e.g. in Moscow);
 - possibility to submit additional (corrected) documents in case of registration denial without repeated payment of the respective state duty (in force starting October 1, 2018);
 - possibility for interested persons to subscribe to relevant registration news regarding selected companies on the website of registration authorities in order to manage possible future registrations of changes in these legal entities and to be able to file objections to these registrations.

2. Cancellation of state duties for registration of subsidiary companies when filing documents in electronic form (in force starting January 1, 2019)

Despite legal actions to make it easier for foreign companies to set up their business in Russia, some negative facts are seen during the establishment of subsidiaries as well as representative offices and branches in Russia.

Unofficial toughening of requirements on shareholders, members of managing bodies (especially general managers), legal addresses and rented premises of the subsidiaries, and registration documents; additional checks and (sometimes long-term) coordination procedures with registration authorities (officially declared reason: fighting illegal business). Examples:

preliminary checks of registration documents before filing, examinations of future managing directors at the premises of registration bodies (several examinations within one procedure are possible), on-site inspections of the premises, and direct communication of registration bodies' representatives with owners of the rented premises.

Temporary suspension of registrations for an additional check of the data on the company to be included in the Unified State Register of Legal Entities (EGRUL), which often happens due to registration of changes in the company.

Checking the data already included in the EGRUL regarding addresses, shareholders, or managing directors of the companies, which can be marked as "mass" ones (acting in the respective capacity in more than five companies). Respective marks are made in the register and can be corrected after corresponding changes in the company are made. If no changes are made within 6 months, the company may be excluded from the EGRUL.

Registration bodies often inform the servicing banks of the companies about the above-mentioned checks of suspicious data and can even recommend blocking the company's bank accounts if the prescribed changes

are not made. The banks' reaction can be different, e.g. all electronic banking services can be blocked until the changes are made.

Servicing banks are also steadily toughening their requirements for document sets prepared by companies for opening bank accounts and their further maintenance (e.g. due to

changes in the company). The paperwork necessary for opening accounts in one bank is nearly always overwhelming.

Registration (tax) authorities also cause difficulties in accrediting representative offices and branches of foreign companies. Though the state duty for accreditation is quite high and amounts to RUB 120,000 (about EUR 1,500), state bodies often deny accreditation based on formal bureaucratic grounds without returning the previously paid state duty.

Overall the trend is positive and working with governmental bodies became more practical. Nevertheless, setting up a business should be carefully planned and receiving professional advice from experienced consultants is advisable. There are a fairly high number of well-established international law firms, tax specialists, and consultants to support companies in any language. ■

Setting up a business should be carefully planned and receiving professional advice from experienced consultants is advisable.

Beneficial ownership concept: how it could affect your business in Russia



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Confirmation is *de facto* one more step in further implementation of the beneficial ownership concept in Russia. Importantly, both documents should be submitted prior to the moment that payments are effected. The tax certificate should be provided at least annually, sealed with the apostille, translated into Russian, and notarized. The minimum requirement for confirmation is the income recipient issuing it with signatures of the authorized parties and its translation into Russian. There is no clear position regarding the regularity of submission of confirmation. Based on the conservative approach, it should be submitted before each payment. Considering the real practice in the MNEs groups, this should be done at least quarterly. If a Russian company fails to obtain at least one of these documents prior to payment to the relevant foreign entity, then it must withhold the relevant withholding tax amount based on the Russian Tax Code. Later on, a foreign company may still claim back the relevant withholding tax.³

Confirmation of the actual right to income

There is no statutory form for confirmation. The Russian Tax Code⁴ simply states the need for such confir-

Nearly every Russian company belonging to a multinational group of companies has inter-company or cross-border arrangements which might be especially attractive due to applicable double taxation treaty (DTT) incentives allowing reduced withholding tax rates or taxation only in the country of the recipi-

ent of such income. Russian companies may also pay out dividends subject to participation exemptions provided in the DTTs.¹ In order to apply such DTT incentives, a foreign recipient should provide a Russian company with the certificates of tax residency and, starting from 2017, with confirmation of the recipient's actual right to such income.²

¹ Participation exemption makes it possible to apply a reduced withholding tax rate (usually 5%) in the country of payor of income if certain thresholds regarding the capital or investment share are met.

² Paragraph 1 of Article 312 of the Tax Code of the Russian Federation

³ Paragraph 2 of Article 312 of the Tax Code of the Russian Federation

⁴ Paragraph 1 of Article 312 of the Tax Code of the Russian Federation

mation and it is up to the taxpayer to decide on the extent of the details of information/documents to be provided. It might be reasonable to prepare a less detailed paper, which, however, should contain all the necessary data regarding the recipient company (information on employees, assets, office, financial information, etc.) in line with beneficial owner criteria (see below) and be adjusted to a specific transaction(s). Further, more detailed information may be prepared as a so-called “defense file” and may be provided later upon

residence; and audited IFRS financial statements and any other documents evidencing the real power to dispose of the received income. The formal availability of both documents (the certificate and the confirmation) seems to not always be helpful, as the Russian company should also be able to prove that the foreign recipient is a beneficial owner. Failure to provide the relevant proof can completely disallow DTT incentives, which will result in an additional tax charge together with penalties and late payment interest.

have interpreted the beneficial owner (BO) concept more broadly than the one provided by the OECD. Notably, the letters of the Federal Tax Service serve mainly as mandatory guidelines for the local tax authorities in order to ensure the uniform application of tax legislation. They are generally not binding for the taxpayers. In reality, they may affect the practice by changing the interpretation and causing new controversies.

Beneficial owner criteria for tax purposes

The Russian Federal Tax Service emphasises a substance-over-form approach to fighting tax avoidance. The criteria⁷ for proving that a foreign entity is a beneficial owner of income derived in Russia include, but are not limited to:

- independence of directors in decision-making;
- power to dispose of the received income;
- real business activities;
- sufficient resources for such activities (office, employees, assets);
- no back-to-back transactions (lack of obligation of the recipient to transfer the income onwards);
- actual assumption of risks by the recipient regarding its assets.

In the view of the Federal Tax Service, the tax authorities are allowed to deny tax treaty benefits when a foreign entity has no active operating business. They may not investigate who the real BO is, and so the mere fact that the first recipient is not a BO is sufficient for applying domestic withholding tax rates.

In order to apply double taxation treaty incentives, a foreign recipient should provide a Russian company with the certificates of tax residency and with confirmation of the recipient’s actual right to such income.

request of the tax authorities. Such approach would give a taxpayer certain leeway and may serve for a better and more flexible position in case of disputes with the tax authorities. There is no statutory list of the defense file’s documents that may support confirmation. According to the Ministry of Finance⁵, the following documents may be required: agreements, arrangements, and contracts of any kind concluded with a third party that can provide confirmation of the active business of the foreign company; tax returns and reporting, other similar documents confirming tax payments in the country of

Beneficial owner concept in Russia

The concept of beneficial ownership of income was implemented in the Russian Tax Code in 2015.⁶ In general, this concept means that the foreign recipient of income may be denied DTT benefits if it has no independent right of use and/or enjoy such income, or if this right is limited, or if it bears insignificant risks and has intermediary functions. There are also provisions on beneficial ownership in DTTs between Russia and other countries. Several guidance letters issued by the Russian Federal Tax Service and the Russian Ministry of Finance

⁵ Letter of the Russian Ministry of Finance No. 03-08-05/76939 dated November 21, 2017

⁶ Article 7 of the Tax Code of the Russian Federation

⁷ Letter of the Federal Tax Service No. CA-4-7/10261 dated May 17, 2017

In the view of the Federal Tax Service, the tax authorities are allowed to deny tax treaty benefits when a foreign entity has no active operating business.

The list of criteria has been expanded recently⁸: it is now important for the taxpayer (or tax agent) to prove the non-tax purpose of a transaction, i.e. that the main aim of the transaction is not to obtain tax benefits. Furthermore, in the view of the Federal Tax Service, a foreign recipient company may not be a BO, but rather an intermediary (conduit) entity, and, thus, having no right to DTT benefits, if the major part of the income of such company originates from Russian sources, whereby such company has no ordinary business other than receiving dividends and/or further redirecting of income to persons who may not obtain the relevant DTT benefits. Further indicators of the intermediary function may be: the absence of typical business payments; insignificant operating expenses; most of the costs are administrative and relate to the formal fulfillment of statutory requirements of the country where such company is residing; income from Russian sources is taxed at low rates or is tax exempt in the recipient's country. Notably, the Russian tax authorities apply the BO concept not only to dividends, interest, and royalties, but also extend it to any other source income, and they also ap-

ply it to both related and non-related parties' transactions. The Russian court practice on BO matters usually upholds the tax authorities, whereby decisions in favour of the taxpayers also exist, but are rather rare.

OECD approach matters

Though not a member of the OECD, Russia upholds most of the OECD initiatives. Generally, the tax authorities and courts accept references to OECD Model Tax Convention Commentaries.⁹ Russia has also joined the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting¹⁰ ("MLI"). MLI is aimed at implementing DTT measures to update international tax rules, and it should also reduce tax avoidance by multinational enterprises (MNEs). MLI is currently in force, and Russia is very close to ratifying it. MLI contains provisions on limitation of benefits (LOB) and outlines the application of the principle purpose test (PPT). The LOB clause sets forth several conditions to be met by a company claiming DTT benefits. If none are met, the company is not a "qualified person" and shall not be entitled to DTT benefits, even if that company qualifies as a resident of

one of the contracting countries under DTT. The presence of an active, operating business run by the company, similar to the BO criteria envisaged by the Russian Federal Tax Service, is also among LOB conditions. The PPT should help to determine whether "one of the main purposes of an arrangement or transaction" is to obtain the benefits of the tax treaty, and, if so, the tax authorities may deny treaty benefits unless it is established that granting that benefit in that circumstance would be in accordance with the object and purpose of the relevant DTT. The ratification of MLI might give even more power to the tax authorities since the ratified MLI is a legal act unlike guidance in the form of letters issued by the tax authorities.

Conclusions and practical considerations

With the Federal Tax Service's approach becoming more strict and aggressive, new challenges for MNEs will likely arise. In particular, local tax authorities may more closely examine the cross-border payments made by Russian subsidiaries to foreign affiliates, and also examine backwards regarding the periods that are still open for field tax audits (three years preceding the year in which the audit is designated).

The main consequences of application of the BO concept can be the limitation of benefits under DTTs as well as reclassification of the transaction in question for tax purposes. For example, when loan interest is considered as a dividend under the relevant

⁸ Letter of the Federal Tax Service No. CA-4-9/8285 dated April 28, 2018

⁹ Commentaries on the Articles of the Model Tax Convention on Income and on Capital. The latest version of the Convention is available in the condensed version from 2017: OECD (2017), Model Tax Convention on Income and on Capital: Condensed Version 2017, OECD Publishing, Paris, https://doi.org/10.1787/mtc_cond-2017-en. It is also questionable whether it is justified to refer to Commentaries in the later version of the Convention if the relevant DTT was signed before this later version.

¹⁰ <http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm>



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changes to the taxation and there is subsequent charging of additional taxes, or when an array of transactions is treated as a tax scheme and the provisions of national tax legislation are applied to the shifted profit.

Considering the changing environment in relation to the cross-border arrangements, MNEs may wish to define the BO position more clearly. As a first step, it would be wise to check whether the tax certificates and confirmations in relation to cross-border arrangements are available and whether they are duly prepared (apostille, translation requirements, etc.). The whole MNE group's structure and cross-border arrangements, including those with non-related parties, should also be reviewed to indicate foreign recipients, including licensors, holding companies, companies performing purely treasury or administrative functions, where the tax position may be challenged based on the BO approach of the Russian tax authorities. Considering this, the defense files containing documents supporting the BO position should be prepared, and in some cases re-thinking and reviewing the whole contractual/holding structure may be needed. Notably, entities may apply a "look-through" approach and disclose a higher tier or a parent company that may be found more compliant with BO criteria. This was the case, for instance, for ZAO Bank Intesa¹¹, where interest was paid to the Luxembourg entity on loans borrowed from this entity belonging to the Italian company. According to the Russian-Luxembourg DTT, interest should be taxed in Luxembourg only. During the tax audit, the tax authorities concluded that the



Luxembourg entity was not a BO with respect to this income and denied the application of the Russian-Luxembourg DTT. Instead of the domestic withholding rate of 20%, the tax rate of 10% according to the Russian-Italian DTT was applied. At the same time, it might not always be possible for the MNEs group to declare a "look-through" approach or to rebuild the existing structures in a short time, as this may cause consequences for transfer pricing purposes of the whole group or trigger tax exposures or tax complications in other jurisdictions. Any adjustments to the structures would obviously require a lot of time and significant effort for analysis from the perspective of different jurisdictions and other aspects important for

the whole group. As a temporary solution in such cases may serve the introduction of caveats and gross-up provisions with respect to payments made by the group's Russian companies. This could also be a feasible solution for transactions with non-related parties who might not be willing or ready to provide information/documents for building up a defense file that is sufficient for Russian tax purposes. To summarise the above: it has become crucial to follow up the approach of the tax authorities on a regular basis, and also further developments in the court practice regarding BO matters and implementation of MLI, in order to hold a strong position in tax matters and be able to provide adequate responses to support this position. ■

¹¹ Decision of the Arbitration Court of the Moscow District No. A40-241361/2015 dated October 4, 2016

How can sustainability drive your business in Russia?



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many cases, this is the direct result of Russian operations executives' skepticism about the sustainability initiatives of their headquarters. Sustainability is often considered not in-demand by the government and public in Russia. Green initiatives are not viewed as conducive to an increase of sales in the Russian market, and sustainability-related projects are often abandoned.

Yet companies with this attitude simply lose momentum on the Russian market. The situation, as we see it, is somewhat like in the 1990s, when some companies were saying "we do not need an internet page, we are not an internet company".

Why does sustainability matter in Russia?

Until recently, the Russian government paid little attention to sustainability. Affordable costs for producing electricity, rich oil & gas deposits, and a well-developed forest industry all prevented the country from adopting "the principle of preserving the environment for future generations" as a national priority. However, over the last decade Russia has been under more pressure to adopt sustainable practices.

The trend of import substitution in the Russian market has shown that Russian enterprises are inefficient and have very high energy costs.

Today, everybody is talking about green values and sustainable development. Politicians, businessmen and leaders of non-governmental organisations emphasise their commitment to UN

Global Goals, and express support for the principles of a circular economy. However, the Russian operations of global companies are typically focused on to a much lesser degree in corporate sustainability reports. In

Russia remains the world's fourth largest energy consumer according to Enerdata statistics (behind China, USA and India), but has substantially lower economic productivity than its peers. This moved Russian authorities to develop and adopt a new energy efficiency plan in 2018.

The operations of outdated enterprises, especially located in cities with historically high industrial development and large populations (Chelyabinsk, Omsk, etc.) also caused significant impacts. To address this issue, in 2014 the mandatory transition of enterprises with high environmental impacts to the best available technologies began, involving modern technologies approved to limit pollutant discharges.

In 2018, public protests related to air pollution from overloaded waste landfills demonstrate the new role of waste

management in the government's agenda. Now pollution is not only an environmental issue, but an important factor of social stability impacting the reputation of governors and ministers.

2014, and substantially increasing the amounts of existing fees. The government is planning to spend up to 1.5 trillion roubles for the Environment National Project from now through 2024, part of the funds of which will be raised from businesses.

However, Russia has its specific national characteristics when it comes to implementing a sustainability agenda. For instance, there is no universal sustainability agenda in Russia. This responsibility is fragmented and divided between various ministries. There is an agenda for energy efficiency that has its own goals, key performance indicators and incentives, with the Ministry of Energy and the Ministry of Economic Development supervising this field in general. There is also a distinctive waste management agenda as part of which the Ministry of Natural Resources and Environ-

ment oversees environmental protection, the Ministry of Industry and Trade oversees the development the recycling industry, and the Ministry of Construction, Housing and Utilities is in charge of waste collection and landfill management. Finally, there is a digital agenda with both the Ministry of Digital Development, Communications and Mass Media and the Ministry of Economic Development as prime stakeholders. Decreasing paper use through e-document management and electronic public services are also

parts of the digitization of the Russian economy. Currently, the development of sharing economy services (collaborative consumption) is likewise an active trend in Russia.

How is the sustainability policy framework set?

There are several legislative sources from which the framework of the meaning of "sustainability" can be understood:

- *the Presidential Executive Order on National Goals and Strategic Objectives of the Russian Federation through 2024.* This document is a programme of the President establishing the development of the environmental and digital spheres as key state priorities to be elaborated in other legislative sources;
- *the Draft Plan of the National Environmental Project.* This Draft Plan focuses on waste management and decreasing water and air pollution in Russia;
- *the Comprehensive Energy Efficiency Improvement Plan.* This Plan sets targets to increase energy efficiency per unit of GDP by 23% by 2030 compared to the base level of 2016;
- *the Digital Economy State Programme.* This Programme describes the digital transformation of industrial processes and the built space to decrease the consumption of resources.

It may be assumed that the approach to sustainable development in Russia is concentrated around the concept of the three R's: reduce, reuse and recycle. Recycle relates to the development of waste management,

There is no universal sustainability agenda in Russia. This responsibility is fragmented and divided between various ministries.

management in the government's agenda. Now pollution is not only an environmental issue, but an important factor of social stability impacting the reputation of governors and ministers.

Finally, environmental protection has become an important smokescreen for the government to use to receive additional budget revenues. In recent years, the government has been introducing new fees for businesses related to the environment, such as the recycling fee for consumer goods in

ment oversees environmental protection, the Ministry of Industry and Trade oversees the development the recycling industry, and the Ministry of Construction, Housing and Utilities is in charge of waste collection and landfill management. Finally, there is a digital agenda with both the Ministry of Digital Development, Communications and Mass Media and the Ministry of Economic Development as prime stakeholders. Decreasing paper use through e-document management and electronic public services are also



reduce – to using less energy by increasing energy efficiency, and reuse – to the digital economy (more narrowly, the sharing economy). All of these can create both risks and opportunities for businesses.

Recycling (waste management)

Waste management reform began in Russia in 2014, but until recently enjoyed very limited success. The national recycling rate remains at the pre-reform level of 7%, according to Federal Statistics Service data. The 2018 Presidential Executive Order sets the target to recycle all waste in Russia.

Risks

Increased financial burden. Since 2016, an environmental fee has been imposed on the producers and importers of consumer goods and packaging in Russia. While the current level of payment does not put serious pressure on the market (annual budget revenues are estimated at 1.5

to 3 billion roubles, based on various sources), the government is already considering substantially increasing fees, as well as including them in the tax code, which would make their non-payment a criminal offense.

Market access barriers. According to several initiatives, certain types of products considered non-sustainable should be banned in Russia. Examples include banning plastic bags as proposed by the Ministry of Natural Resources and Environment, and market restrictions on disposable tableware. The barriers, however, may also be created for services. The Russian government is actively considering the creation of a national monopoly in the field of waste management, which would limit the opportunities for other waste management operators in the market.

Opportunities

Business development for waste management-oriented projects. The gov-

ernment is planning substantial spending on waste management projects across Russia, including the construction of waste recycling plants and the rehabilitation of landfills. The potential to participate in state programmes for waste management presents serious opportunities for business development.

High-profile marketing. Today, Russian authorities are especially open to contractors providing support in waste management-oriented projects. For instance, the Ministry of Natural Resources and Environment has already signed a memorandum of understanding with some of the top international consumer goods and petrochemical companies, and the Ministry of Industry and Trade has officially supported the used batteries collection project implemented by a top global batteries manufacturer. Official support from the authorities can be used as a high-profile marketing tool.

Reduce (increasing energy efficiency)

Energy efficiency was a part of Russia's "innovations" agenda and one of the key state priorities from 2008-2012. The new Comprehensive Energy Efficiency Improvement Plan was adopted by the government in 2018 and received a new supervisor, namely the Economic Development Ministry.

Risks

Carbon tax. The Paris Agreement has still not been ratified by Russia. However, the most anticipated mechanism for its implementation is the introduction of a carbon tax (rather than the formation of a carbon trading system). This would create a new non-tax payment in Russia.

Administrative barriers. Russia has been trying to create a national system of energy efficiency-related technical regulations different from its European analogue. One remarkable example is the Government Order on Lighting Solutions and Electric Light-bulbs, which introduced requirements for energy efficient lighting solutions different from those adopted in the EU. This formed a barrier for global manufacturers working in the Russian market.

Opportunities

Tax benefits. Tax incentives for energy efficient immovable assets are present in the Russian Tax Code. Companies constructing energy efficient buildings have the right to claim financial benefits under these tax incentives.

Green finance. The Plan for Energy Efficiency Improvements is one the first regulatory enactments in Russia arguing for the development of green finance instruments, mainly green

bonds. VEB, Russia's development bank, is appointed as a key institution in the field. Other government banks, including Sberbank and VTB, already offer green finance services.

Reuse

The digital economy is a potential area of development for Russia, given its historical strengths in technology. Furthermore, the sharing economy is particularly related to sustainability as a system in which services that enable peer-to-peer exchange are given priority, and overall products are viewed rather than services and not goods. This allows for a decrease in consumption levels, which directly benefits the environment. The sharing economy is being developed at both federal (State Programme for the Digital Economy) and regional levels (particularly in large cities, such as Moscow and St. Petersburg).

It may be asserted that this field has no risks, only opportunities. One of the most exemplary is market access for short-term renting platforms for locations with a relatively low number of traditional hotels. Another situation concerns the mobility on demand services in Moscow (MaaS). The Moscow Smart City programme also opens up many opportunities for innovative businesses.

What to do?

Making the opportunities set by the government's sustainability agenda a reality would not have the immediate effect of growing a company's business in Russia. However, the sustainability agenda is developing and will likely become a significant part of state policy over the next decade. Therefore, working with sustainability issues is an important measure to secure market

access in that timeframe. It will help companies receive positive attention from government sector stakeholders, and also win loyalty among consumers starting to get more interested in the sustainability efforts of corporations. In the meantime, companies operating in Russia should avoid going to either of the two extremes.

The first extreme is focusing on a global corporate sustainability agenda without paying attention to the regional specifics of the Russian market. The stakeholders here are less sensitive to issues of global warming, but they care a great deal about reducing waste generation.

The second extreme is being pushed around by local stakeholders. For instance, regional authorities confuse sustainability with charity. It may be difficult to explain to them that the environmental programme is of higher importance than the renovation of a local school gym.

It is always important to educate stakeholders about the efforts already made by the company. Since 2016, a draft law on non-financial reporting has been discussed in Russia. While it has not yet been approved, it is clear that the trend towards reporting is developing. Moreover, active reporting is strengthening businesses' position in discussions about sustainability-related regulations by showing they are already making serious efforts in this field.

Sustainability efforts do not bring immediate results, but right now, when the government's efforts in the field are only beginning to evolve, is the ideal time to secure a place for the future development of your business. ■

Part IV.

Sharing

experience

Investing in Russia and beyond: a case of Servier



JÉRÔME GAVET

Managing Director, Servier Russia
and EAEU countries

Jérôme Gavet joined Servier Group in 1999.

He was appointed as a General Director of Servier Russia in 2007, and became a Managing Director of Servier EAEU platform in 2016.

Russian authorities: a focus on the pharmaceutical market

Healthcare is one of the strategic priorities of the Russian government. In 2018, the Ministry of Health developed a draft of the National Healthcare Project, which is designed to decrease mortality by improving the quality of care and its accessibility for the Russian patients, as well as by promoting a healthy lifestyle to reach the target of life expectancy up to 78 years by 2024.

The implementation of the "Pharma 2020" has been continuously carried out for almost 10 years to address issues facing the Russian pharma-

ceutical industry, including market dependence on imported goods, regulatory barriers during registration, quality control of drug circulation, etc. "Pharma 2030" strategy is currently being drafted, and focuses on further development of the technological competences for local pharmaceutical production, stimulation of R&D localisation and non-commodity export development. At Servier, we are committed to developing our export potential and capabilities from Russia to the Eurasian Economic Union (EAEU), and planning further export activities to Central Asia and the European Union.

For us Russia has always been a strategic priority. Many pharmaceutical companies perceive the establishment of the EAEU common market in 2015 as a new opportunity for the regional development. As far as Servier is concerned, in 2016 we established a single regional platform for EAEU and Central Asia that enlarged our footprint and operations in these countries. So, this year we entered into a Cooperation Agreement with Kazakhstan Government. We met with the Prime Minister and the Minister of Health of the Republic of Kazakhstan and discussed opportunities for contract manufacturing production development, as well as collaboration on joint scientific projects in various therapeutic areas. We carry out a number of educational and awareness campaigns in the field of prevention and treatment of non-communicable diseases (NCDs), including cardiovascular diseases (CVDs) and diabetes.

Advantages of production localisation in Russia

One of our main steps forward in Russia came in 2007, when Servier built its own plant "Servier RUS" in Moscow and transferred innovative technologies.

Today, "Servier RUS" is a full-scale pharmaceutical plant producing 96% of its original medicines portfolio for the treatment of major NCDs, which remain among the main causes of morbidity, mortality and disability. The quality management system covers all aspects of production and guarantees full conformity with our corporate standards, international good manufacturing practice (GMP) requirements, and Russian legislative norms. The Industrial Complex Status we obtained from the Moscow government in 2016 provides us with additional opportunities to continue implementing our long-term investment strategy in Russia, and contributes to new technologies, new products as well as the modernisation of treatment facilities to conform to the most advanced environmental standards.

Today, we are starting a new page in our partnership with Russia by offering our production capacities to the third parties through contract production. We intend to make "Servier RUS" an attractive platform for leading companies to produce their own innovative medicines. This point is illustrated by the manufacturing pro-

duction agreement we signed in 2018 with GSK/ViiV Healthcare to localise the production of anti-HIV drugs. We believe this collaboration will contribute to increasing access to innovative medicines for patients in Russia suffering from this socially important disease. We are also open to further partnerships with local manufacturers to expand our product localisation in Russia.

As far as drug safety is concerned, in 2012, Servier launched its own continuous quality monitoring and control system for manufactured products, SecuriStamp®, which guarantees the authenticity of our drugs. In 2016, "Servier RUS" also joined the state pilot Track & Trace (T&T) system project initiated and run by the Ministry of Industry and Trade, the Ministry of Health, the Federal Service for Surveillance in Healthcare (Roszdravnadzor) and the Federal Tax Service.

Investments through driving innovations

Servier Group annually invests 25% of its turnover in R&D and focuses on five key therapeutic areas: CVDs, neurodegenerative diseases, diabetes mellitus, immune inflammatory and oncology diseases. This investment and collaboration with the leading scientific and research laboratories and institutes around the world brought the company success in creating a significant bunch of medicine candidates with unique mechanisms of action.

By maintaining its strong position in cardiology and diabetes, Servier intends to become a world reference in oncology, which is also one of the company's priority areas for R&D. To

illustrate this, two years ago oncology accounted for 14% of R&D investments, but has now grown to 37% and is expected to reach 50% over the next two years.

Many pharmaceutical companies perceive the establishment of the Eurasian Economic Union common market in 2015 as a new opportunity for the regional development.

Servier has been operating in Russia for more than 25 years. Exploring our investment strategy, even in 1999, we established in Moscow our own International Centre of Therapeutic Research to organise our clinical research and contribute to the development of our international clinical trials in Russia and other EAEU countries.

The Business Development strategy for EAEU countries reflects our global therapeutic approach mentioned above. Today, the Servier portfolio in Russia contains 17 drugs, and we plan to double that figure in the following five years. We also continue our diversification efforts in the OTC segment, which is among its strategic lines due to the specifics of the local pharmaceutical market.

An emphasis on sustainable business development

Servier is committed to sustainable business development through its own Corporate Social Responsibility (CSR) activities, which contribute to resolving major economic, environmental, social and societal issues. For example, in 2017, Servier allocat-

ed funds for a joint project with Rusfond to co-finance the treatment of seriously ill children. In 2018, in partnership with the society for Parkinson's disease patients, the "Parkin-

son's disease patients school" project was launched. This year we became a partner of the Moscow government programme of longevity organised by the Troitsk city Administration. In partnership with the International Society of Hypertension, we carried out a large-scale public awareness campaign to encourage the population to get their blood pressure check regularly.

We have a staff of over 1,300 in our Russian subsidiary, including "Servier RUS". Despite this constantly growing number, we manage to maintain a friendly and encouraging atmosphere, where employees can demonstrate their individual skills and feel valued. This results in a very low staff turnover, particularly 6,59% at "Servier RUS" in 2017-2018. Focusing on positive energy, strengthening our team spirit, promoting cross-functional collaboration and being selective in our choices are all essential ingredients of our performance. We look forward to the future and intend to develop our innovative therapeutic solutions that contribute not only to increased life expectancy, but also to improved quality of life of the Russian patients. ■

For notes



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2. CATEGORY/КАТЕГОРИЯ: THE CATEGORY IS DETERMINED ACCORDING TO THE WORLD'S TURNOVER OF THE COMPANY Please attach the information letter on the activity of the company and its annual turnover with the signature of the head of the company on the official letterhead

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