Russian Federation

David M Wack and Christopher A Rose
Squire, Sanders & Dempsey LLP

www.practicallaw.com/9-501-0117

MARKET AND INCENTIVES

1. Please describe briefly the private equity market in your jurisdiction, in particular:

- **The sources from which funds established to invest in private equity transactions (private equity funds) obtain their funding, such as institutional investors (for example, pension funds, insurance companies and banks), companies, individuals and government agencies.**
- **Market trends (for example, the role of hedge funds in private equity).**
- **Any proposed or pending regulatory changes.**

Sources of funding

Private equity funds obtain funding from a variety of sources, including:

- Endowments.
- Family offices.
- High net-worth individuals.
- Foreign pension funds.
- Development finance institutions (particularly over the past ten years), including the:
  - European Bank for Reconstruction and Development (EBRD);
  - International Finance Corporation (IFC);
  - US Overseas Private Investment Corporation (OPIC).

Geographically, significant levels of capital have recently come from:

- Western Europe.
- Scandinavia.
- Asia.
- North America.

A growing trend is seeking funding from domestic sources, such as government-funded programmes (*Russian Private Equity and Venture Capital Association (RVCA)*) (*see box, Private equity/venture capital association*). Compared to many other jurisdictions, local pension funds are notably absent as a source of funding for private equity because of legal restrictions on allocations to alternative asset classes.

Market trends

Russia and the CIS reportedly outperformed all other markets in private equity returns over the past three, five and ten years, including the US, Europe and all other emerging markets (*EBRD*). The value of private equity deals increased by 76% in 2008 compared to 2007, but investments decreased by 84% in the second half of 2008 compared to the same period in 2007. Reliable statistics are currently unavailable for the first half of 2009. However, deal activity during this period is generally believed to be at or lower than the level of the previous six months. This indicates that the international financial crisis has dramatically altered the market landscape for private equity opportunities and transactions.

While macro-economic volatility remains a major obstacle for private equity investment in the short term, many experts believe that the Russian Government's policy responses to the economic and financial crisis have generally been adequate. Russia's financial situation stabilised in the second quarter of 2009 and the Central Bank has so far successfully fended off a banking crisis and stabilised the rouble despite:

- The burden of a growing budget deficit.
- High unemployment in industry-dependent cities.
- Large outstanding corporate debt.
- A weak banking sector.
- High inflation.

With increased government spending in early stage companies, including through the Russian Corporation of Nanotechnologies (RUSNANO), the venture capital landscape is expected to change in the short and medium term. The priority of RUSNANO is commercialisation of nanotechnology projects with high business potential and/or social benefit. RUSNANO manages RUB130 billion (about US$4.4 billion), provided solely by the Russian Government.

Regulatory changes

On 9 June 2009, Federal Law No. 208-FZ, 26 December 1995 on Joint Stock Companies was amended to allow the use of shareholders' agreements. Previously, the enforceability of these agreements in relation to joint stock companies was the subject of considerable debate, as many common provisions in these agreements conflicted with Russian law. Similar amendments to Federal Law No. 14-FZ, 8 February 1998 on Limited Liability Companies came into effect under which members of limited liability companies can conclude shareholders agreements.

Despite this recognition of shareholders' agreements by Russian law, it is too early to ascertain to what extent courts will enforce these agreements or how shareholders' agreements will work in practice.

Legislation currently prohibits debt to equity swaps. Accordingly, these transactions traditionally take place offshore. A recent draft law proposes eliminating prohibitions on debt to equity swaps in relation to Russian companies. However, even if this legislation is adopted, other legal provisions must be significantly amended before debt to equity swaps become a viable option for the private equity industry.

2. Please summarise any changes in the level of activity in recent years in relation to:

- **Fundraising by private equity funds and hedge funds.**
- **Private equity investment in established, early stage and start-up businesses.**
- **Private equity financed transactions (for example, management buyouts (MBOs), management buy-ins (MBIs), leveraged buyouts and public to private transactions).**
- **Exits from private equity funds (that is, the realisations of the investments).**

Fundraising

The total value of newly-raised funds was about US$4.27 billion (about EUR2.92 billion) in 2008, which is roughly approximate to the 2007 figure (US$4.32 billion (about EUR2.95 billion) (*RVCA*). Notably, three of the newly-established funds in 2008 represented almost half of all funds raised.

Private equity firms managed US$14.3 billion at the end of 2008, which is 40% more than in 2007 (US$10.3 billion (about EUR7.04 billion)) (*RVCA*). Funds raised from Russian sources (46%) were almost equal to foreign capital (54%) raised in 2008. However, this can be misleading as the figures include venture funds established as public-private partnerships. 155 private equity and venture capital funds were active in 2008 (*RVCA*).

Investment

There were 120 reported transactions in 2008, totalling about US$1.47 billion (about EUR1 billion), compared to 85 transactions in 2007 and 65 in 2006 (*RVCA*). If several other undisclosed transactions are included for 2008, the aggregate estimated value of investments is about US$2 billion (about EUR1.37 billion).

The consumer goods and services market was the largest sector for total investment, receiving US$596.4 million (about EUR407.8 million) in financing, representing just over 40% of total investments in 2008 (US$487.46 million (about EUR333.33 million) or about 48% of total investment in 2007). The biotechnology and power industries attracted significantly more investment in 2008 than 2007, with biotechnology receiving US$29.43 million (about EUR20.12 million) (US$1.98 million (about EUR1.35 million) in 2007) and power receiving US$75 million (about EUR51 million) (US$1 million (about EUR0.68 million) in 2007).

Expansion stage deals continue to be the most attractive for investors, comprising 89% of all investments in 2008. 6% of transactions in 2008 were early stage and about 5% were seed-level stage (*RVCA*). The average transaction size in 2008 was about US$12 million (about EUR8.2 million).

Exits

There were 21 exits in 2008 (*RVCA*). Sales to strategic investors (20) accounted for 95% of total exits (17 trade sales in 2007, being 71% of total exits). There was one MBO and no private equity-backed IPOs in 2008.

3. What tax incentive schemes exist to encourage investment in unlisted companies? At whom are the schemes directed? What conditions must be met?

There are no tax incentive schemes to encourage investment in unlisted companies.

FUND FORMATION

4. What legal structure(s) (domestic or foreign) are most commonly used as a vehicle for private equity funds in your jurisdiction?

Private equity funds formed under Russian law are typically organised as closed investment funds (PIFs) and are regulated by the Federal Commission for the Securities Market (FSCM) in accordance with the Law on Investment Funds (*No 156-FZ, 29 November 2001*). However, as most major private equity funds are established under foreign law, the focus of this article is on offshore fund structures.

The most common offshore structure is a limited partnership formed in a reputable, tax-advantaged jurisdiction like Bermuda, British Virgin Islands, Cayman Islands, Isle of Man, Guernsey or Jersey. Often, the general partner and possibly a manager are incorporated in the same jurisdiction as the fund. In addition, a Russian company or a foreign company with a branch office located in Russia acts as a local investment adviser.

Russian source income received by a foreign entity other than through a permanent establishment in Russia may be subject to Russian withholding tax. Accordingly, fund investments are typically made through Cyprus, Luxembourg or Dutch holding companies, thereby taking advantage of the favourable double taxation treaties these jurisdictions have with Russia.

5. For each structure identified in *Question 4*, identify whether it is taxed, tax exempt or fiscally transparent (that is, tax is levied on the individual investors rather than the fund itself):

- **So far as domestic investors are concerned.**
- **So far as foreign investors are concerned.**

Offshore limited partnership vehicles (*see Question 4*) are fiscally transparent for foreign investors. However, the special purpose vehicles through which these limited partnerships typically invest

in portfolio companies are subject to withholding taxes on dividends, interest and capital gains in accordance with the applicable tax treaty between Russia and the SPV's jurisdiction.

Due to the Russian tax authorities' relative lack of experience with fiscally transparent structures (flow-through vehicles are generally not legally recognised), it is possible for capital gains derived from investments in foreign limited partnerships by Russian tax residents to be characterised as ordinary income, and therefore taxed at a higher rate. Consequently, Russian investors investing in fiscally transparent fund structures generally hold their interests through a tax-exempt or low-tax offshore company.

6. What (if any) structures commonly used for private equity funds in other jurisdictions are regarded in your jurisdiction as not being tax transparent (in so far as they invest in companies in your jurisdiction)? What parallel domestic structures are typically used in these circumstances?

The concept of partnerships is underdeveloped in Russian legislation. Partnerships are treated as legal entities and their profits are subject to corporate profits tax at the level of the partnership itself rather than at the level of the partners. Profits-tax legislation does not provide for any equivalent to the US check-the-box rules. Accordingly, tax transparent structures (that is, limited partnerships) commonly used by private equity funds in other jurisdictions are generally not used for direct investment into Russian companies. Funds typically employ companies formed in Cyprus, Luxembourg or The Netherlands when investing in Russian portfolio companies, which enable the fund to reduce withholding taxes payable by the holding company through double taxation treaties.

7. Are a private equity fund's promoter, principals and manager required to be licensed?

The management company, custodian and register holder of private equity funds incorporated under Russian law must be licensed. However, all significant private equity funds operating in Russia are established under foreign law and there are no licensing requirements for these foreign funds.

8. Are private equity funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

Private equity funds formed under Russian law are regulated as investment funds. These regulations do not apply to foreign funds and, therefore, do not have any practical effect on how most private equity funds are marketed and advertised in Russia.

9. Are there any restrictions (for example, nationality, age and number) on investors in private equity funds?

There are no restrictions on investors in foreign private equity funds. However, there may be restrictions under the laws of the jurisdiction in which a foreign private equity fund was formed.

10. How is the relationship between the investor and the fund governed? What protections do investors typically seek?

For private equity funds operating as a limited partnership, the relationship between the fund and its investors (the limited partners) is governed by the limited partnership agreement. These funds are managed by the general partner, which has unlimited liability. Investors typically seek to negotiate:

- Restrictions on the types of investments that may be made by the fund.
- Activities of the fund managers.
- Management fees.
- Carried interest.
- Expenses reimbursable by the fund.

11. Are there any statutory or other limits on maximum or minimum investment periods, amounts or transfers of investments in private equity funds?

The term for investment funds formed under Russian law should not exceed 15 years. Russian law imposes no term limits on offshore private equity funds. However, there may be restrictions under the laws of the jurisdiction in which the foreign private equity fund was formed.

INVESTMENTS

12. What are the most common investment objectives of private equity funds?

The most common objective of private equity funds is capital appreciation.

13. What forms of equity and debt interest are commonly taken by a private equity fund in a portfolio company? What are the relative advantages and disadvantages of each? Are there any restrictions on the issue or transfer of shares by law?

Private equity funds generally take equity interests in portfolio companies, although convertible loans are becoming increasingly common.

When investments are made directly (that is, without using an intermediate offshore holding company), private equity funds buy ordinary shares (in relation to Russian joint stock companies) or participation interests (in relation to Russian limited liability companies). Downside protections are typically negotiated in the shareholders' agreement, usually in the form of equity ratchets and puts.

Private equity fund investments tend to be structured through offshore special purpose vehicles. Often these vehicles pre-date the investment, having been formed by the portfolio company's founders. Alternatively, they are formed by the fund for the purposes of the investment. While using these holding companies

is primarily motivated by tax efficiency, governance issues also play a significant role. Russian corporate and contract law are generally inflexible, making certain aspects of typical investment structures unenforceable. Accordingly, foreign law (typically English) is used to improve the enforceability of these investor protections.

There are certain restrictions on the issue or transfer of shares. For example, a shareholder of a joint stock company has a statutory pre-emptive right in relation to new issuances. Shareholders of closed joint stock companies and participants of limited liability companies have a right of first refusal in relation to sales of shares (participatory interest) by other shareholders or participants.

BUYOUTS

14. Is it common for buyouts of private companies to take place by auction? If so, which legislation and rules apply?

Buyouts of private companies by auction take place, but are not yet common. When they do occur, they typically involve auctions of shares at offshore holding company level. In these cases, Russian law is not involved. However, if the auction involves a Russian company, general legislation and rules relating to auctions or tenders apply (*Russian Civil Code No 51-FZ, 30 November 1994*).

15. Are buyouts of listed companies common (public to private transactions)? If so, which legislation and rules apply?

Buyouts of listed companies are uncommon. However, when they occur, buyouts:

- Must comply with the anti-takeover rules promulgated under the Joint Stock Company Law (*No. 208-FZ, 26 December 1995*).
- May require governmental consent under the Foreign Strategic Investments Law (*No. 57-FZ, 29 April 2008*).
- May require the consent of the Federal Antimonopoly Service (FAS).

Anti-takeover rules

Anti-takeover rules provide that:

- Any person intending to acquire more than 30% of an open joint stock company's voting shares (including, for these purposes, the shares already owned by the person and its affiliates) can make a public tender offer to other holders of such shares or securities convertible into the shares (voluntary offer).
- Within 35 days after acquisition by any means of more than 30%, 50% or 75% of such shares the acquirer must make a public offer to buy the remaining shares from the shareholders (compulsory offer).

  If as a result of such voluntary or compulsory offer the acquirer buys more than 95% of the voting shares, it must both:

  - notify all remaining shareholders (within 35 days after acquisition of shares above such threshold) of their right to sell their shares and other securities convertible into such shares;
  - buy such shares on the request of each minority shareholder.
- Alternatively, instead of giving such notice, the acquirer can deliver a buyout demand, binding on the minority shareholders, that they sell their shares.
- An offer of the kind described in the above three paragraphs must be accompanied by a bank guarantee of payment. In addition, prior notice of the offer must be filed with the Federal Financial Markets Service (FFMS). The FFMS may require revisions to the offer terms (including the price) to comply with the anti-takeover rules.

Foreign Strategic Investments Law

Foreign investment in 42 sectors deemed as strategic, is subject to government approval in certain cases (*Foreign Strategic Investments Law*). The 42 strategic sectors include:

- Areas such as oil and gas, and other natural resources.
- Defence.
- Nuclear energy.
- Certain transportation activities (including airports, seaports, rail and pipelines).
- Certain telecommunications and media companies (excluding internet-related).
- Certain electric power and heat transmission businesses.
- Aviation and aerospace.
- Fishing.
- Specialty metals processing.

Specifically, approval is required for:

- Foreign acquisition of a controlling interest in a strategic sector company or more than 10% for a company in the mineral resources sector.
- Acquisition by a foreign state, international organisation or organisation under their control of more than a 25% interest in a strategic sector company or more than 5% for a company in the mineral resources sector.

Approval by the FAS

Under Russian anti-monopoly legislation, which was significantly amended in July 2006, prior FAS approval must be obtained for an acquisition of voting interests in a Russian company over certain thresholds (25%, 50% or 75% for joint stock companies or 33.33%, 50% or 66.66% for limited liability companies) through purchase, creation of a joint venture company, statutory merger or consolidation or the acquisition of more than 20% of the assets of a Russian company where any of the following are met:

- The combined asset value of the target's group and the acquiring group, calculated in accordance with Russian accounting standards, exceeds RUB7 billion (about US$233 million) and the target's group has at least RUB250 million (about US$8.3 million) of assets.

- The combined revenues of the target's group and the acquiring group, calculated in accordance with Russian accounting standards, exceeds RUB10 billion (about US$333 million) and the target's group has at least RUB250 million of assets.
- A company in the target's group or the acquiring group has more than a 35% market share for its goods or services, and is included on the FAS register of monopolists.

In addition, the acquisition of voting interests in a foreign company may be subject to FAS consent if, as a result of the acquisition, control over Russian companies or assets changes and the change of control could affect competition in the Russian market.

16. What are the principal documents produced in a buyout?

Control over Russian joint stock companies and limited liability companies is generally understood as ownership of 75%, plus one share, which gives the acquirer control over all major decisions (subject to minority protection rights).

The principal documents involved in a buyout of a joint stock company are the share purchase agreement and the share transfer order.

If the target is a limited liability company, the principal document is the purchase agreement that should be notarised by a public notary.

Buyouts structured as direct asset purchases are not widely used. Typically, if a straightforward share acquisition is not desirable, the parties establish a newly-formed company (NewCo), usually in the form of a limited liability company, to which assets of interest to the buyer are transferred as in-kind contributions to the charter capital of NewCo and the shares of NewCo are subsequently sold to the buyer.

17. What forms of contractual buyer protection are commonly requested by private equity funds from sellers and/or management?

Private equity funds commonly request customary representations, warranties and indemnities. Depending on the size of the investment, private equity funds also frequently negotiate:

- Equity ratchets for:
  - down rounds;
  - the failure of management to meet financial targets (common when the investment is made on the basis of projected targets);
  - failure to achieve exit by a particular date.
- Puts.
- Purchase price retentions to ensure payment for warranties or specific liabilities are uncommon except in pure buyouts.

18. What non-contractual duties (for example, of confidentiality and employment) do the portfolio company managers owe and to whom (for example, when approaching possible investors in relation to an MBO)?

The Joint Stock Company Law and Limited Liability Company Law have a number of general provisions concerning director and officer duties and liability. In particular, it requires board members and officers to act in good faith and in the best interests of the company, and makes them personally liable for losses incurred by the company that result from actions they took knowingly against the best interests of the company. An additional duty of care and confidentiality may also arise based on the terms of the manager's employment contract.

19. What terms of employment are typically imposed on management by the private equity investor in an MBO?

Management employment agreements typically include provisions concerning:

- Severance.
- Non-competition.
- Confidentiality.
- Financial incentives such as cash bonuses and stock options.

20. What measures are commonly used to give a private equity fund a level of management control over the activities of the portfolio company (for example, representation at board level)? Are such protections more likely to be given in the shareholders' agreement or company bye-laws?

Private equity funds generally require one or more seats on the supervisory board of the holding company through which the investment is made, and veto rights or special quorum requirements in relation to certain major decisions, including approving:

- Business plans.
- Debt or equity financing rounds.
- Corporate changes.
- Major acquisitions.
- Dividends.
- Appointment of key officers.

These protections are usually found in the shareholders' agreement, but certain provisions (that is, veto rights) are often repeated in the holding company's articles.

21. What percentage of finance is typically provided by debt and what form does that debt financing usually take (for example, term loans, working capital facilities, convertible loans and bonds)?

Private equity investments are typically comprised entirely of equity, although convertible loans have recently become increasingly common. True leveraged buyout transactions are still uncommon. Debt, primarily in the form of credit linked notes (CLNs), were popular before the economic crisis, among large, mature Russian companies with predicable cash flow to finance modernisation, expansion or strategic acquisitions.

22. What forms of protection do debt providers typically use to protect their investments, in particular through what types of:

- **Security?**
- **Contractual and structural mechanisms (for example, covenants or subordination)?**

Debt providers typically protect their investments through:

- Pledges over assets and/or shares.
- Third-party guarantees.
- Bank guarantees or sureties.

23. Are there rules preventing a company from giving financial assistance for the purpose of assisting a purchase of shares in the company? If so, how does this affect the ability of a target company in a buyout to give security to lenders? Are there exemptions and, if so, which are most commonly used in the context of private equity transactions?

There are no special rules preventing a company from giving financial assistance to assist a purchase of shares in the company. However, certain jurisdictions through which investments in Russia are commonly made (for example, The Netherlands) do have financial assistance rules, which frequently raise issues in connection with the making of warranties and covenants by the company and grants of equity ratchets.

24. What is the order of priority on insolvent liquidation? Are certain debt providers given priority over other debt providers? Are debt providers given priority over other stakeholders by law or is priority purely a matter of contract and company constitution?

Creditors have the following order of priority during liquidation (*Civil Code*):

- **First priority.** Individuals owed compensation for injury or death, or moral damages.
- **Second priority.** Employees and copyright claims.
- **Third priority.** Federal and local governmental authorities claiming taxes and similar payments to pension funds and social insurance funds.
- **Fourth priority.** Other creditors in accordance with Russian legislation.

Claims of creditors in relation to obligations secured by a pledge of the company's property are satisfied from the sale proceeds of the pledged property before claims of any other creditors, including the creditors of the first and second orders of priority. Sale proceeds of the pledged property are distributed as follows:

- 70% (or 80% if the pledge is a security under a credit agreement) is transferred to satisfy demands for obligations secured by the pledge.
- 20% (or 15% if the pledge is a security under credit agreement) is transferred to a special bank account to satisfy demands of the first and second priority creditors (if there are not enough other assets of the debtor to satisfy their demands).
- Other sale proceeds are transferred to a special bank account for payment of court expenses, bankruptcy manager fees and fees of other persons dealing with the bankruptcy proceeding.

The remaining assets of the company are distributed among shareholders in the following order of priority:

- Payments to repurchase shares from shareholders with the right to demand repurchase.
- Payments of declared but unpaid dividends on preferred shares, and the liquidation value of the preferred shares, if any.
- Payments to holders of ordinary and preferred shares on a pro rata basis.

PRIVATE EQUITY/VENTURE CAPITAL ASSOCIATION

Russian Private Equity and Venture Capital Association (RVCA)

Head. Albina Nikkonen (Executive Director)

Address. PO Box 33
194156, Saint-Petersburg
Russia
T +7 812 326 61 80
F +7 812 326 61 80
E *rvca@rvca.ru*
W *www.rvca.ru*

Status. The RVCA is a non-governmental organisation.

Membership. The RVCA has 39 full members and 34 associate members.

Principal activities. The RVCA promotes and develops the private equity and venture capital industry in Russia and abroad.

Published guidelines. None.

Information sources. The RVCA publishes an annual Yearbook available to its members.

25. Is it possible for a debt holder to achieve equity appreciation through conversion features such as rights, warrants or options?

Such conversion features are possible, but are typically implemented at the offshore holding company level.

PORTFOLIO COMPANY MANAGEMENT

26. What management incentives are most commonly used (for example, shares, options and ratchets) to encourage portfolio company management to produce healthy income returns and facilitate a successful exit from a private equity transaction?

Deferred or share-based compensation, including share option programmes, is being increasingly used to incentivise portfolio company management. In addition, equity ratchets tied to the company's performance and/or a successful exit by a pre-agreed date are also frequently employed.

27. Are any tax reliefs or incentives available to portfolio company managers investing in their company?

There are no tax reliefs or incentives to portfolio company managers investing in their company.

EXIT

28. What forms of exit are typically used to realise a private equity fund's investment in a successful company (for example, trade sale, initial public offering (IPO) and secondary buyout)? What are the relative advantages and disadvantages of each?

Trade sales, management buyouts and management buy-ins are the most frequently used forms of exit to realise private equity fund investments. While IPOs of Russian private equity-backed companies became increasingly common in 2005 and 2006, public offerings have since experienced a decline due to unfavourable conditions in the capital markets.

29. What forms of exit are typically used to end the private equity fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

Unsuccessful investments are normally exited through a trade sale. Alternatively, the company is liquidated.

CONTRIBUTOR DETAILS

David M Wack and Christopher A Rose
Squire, Sanders & Dempsey LLP
T +7 495 258 5250
F +7 495 258 5251
E *dwack@ssd.com*
crose@ssd.com
W *www.ssd.com*