



America *in* Russia

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A positive path forward

ANDREW SOMERS

One of the encouraging signals being sent by advisers to President Obama is the new administration's willingness, even determination, to reach out and weigh new ideas and new approaches in the international sphere, particularly in areas where relations have been frayed or otherwise deteriorated in the recent past. I am happy to report that AmCham was contacted in this respect and invited to submit suggestions for policies the new administration might consider adopting in the near term (defined as the first 180 days) that could prove beneficial to US-Russian relations, with emphasis on economic and business issues. We were pleased to accept this invitation and by the end of January we had submitted our first round of recommendations, reflecting the consensus views of members of the board.

We also took the opportunity to introduce the new administration to AmCham, noting that many of our members are *Fortune 500* companies which in recent years have invested many billions of dollars in the Russian market, resulting in a bilateral business and economic relationship far stronger and more extensive than is generally understood in the United States. We pointed out that for many of our member companies, expansion in Russia has been faster and more profitable than in any other foreign market, including China.

Taking as our cue President Obama's call for "greater cooperation and understanding between nations," we expressed the firm belief that the continued growth and success of US-Russian business relations provides an important example of what can be achieved, and a strong foundation for future cooperation and understanding between our two countries at every level, including significant social and cultural benefits.

Despite the current global economic downturn and specifically its growing impact on the Russian economy, we noted that our companies are confident that they are well positioned to take advantage of the market as soon as conditions improve – which, in turn, will benefit the US economy.

Overall, we expressed the view that the Obama Administration has a unique opportunity to change the tenor of the dialogue with Russia at this crucial moment in history and stressed the importance of engagement with Russia as the most effective means of securing positive outcomes, whatever the particular issue. Our suggestions and recommendations fell into the following broad categories.

Early action

The Russian government is looking for signs of engagement and policy from the new US administration. Positive and visible pronouncements and actions within the first 180 days could be critical, perhaps beginning with business and commercial issues.

Presidential visit

Consideration should be given to an early visit to Russia by President Obama. This in itself would be a significant step toward improving relations. The global financial crisis offers an opportunity to open discussion on a number of topics that even a year ago might have been difficult, if not impossible.

Better, more frequent communication

Ongoing high-level meetings should be scheduled on a regular basis to facilitate cooperation and avert needless misunderstanding. Senior officials of US agencies and departments should establish personal working relationships with their Russian counterparts. Earlier efforts in this direction have fallen off in recent years.

Admit Russia to WTO

The US should take the lead in ensuring that Russia is admitted to the World Trade Organization, preferably by the end of the year. The fact that it is the only major economy not in the WTO is not only a major irritant to the Russian

government, but harms US as well as Russian economic interests. Currently, officials perceive a weakening of American support and are beginning to roll back legislation that would benefit US exports, originally passed in anticipation of WTO membership.

Of equal importance to the US national interest, Russia's accession would substantially serve to normalize geopolitical relations and cooperation between our countries, particularly on regional security issues, such as in the former soviet Asian republics and in the energy-rich Caspian region.

Extend technical support

The US should seek to establish a government-to-government technical support program. This could focus on sharing lessons learned and best practices, for example, in US administrative law, judicial transparency, economic diversification (away from Russia's overdependence on the energy sector), transportation issues and -- notably -- using the Foreign Corrupt Practices Act as a model to support President Medvedev's announced campaign on corruption.

Nuclear agreement

We strongly support the signing of a civilian nuclear cooperation agreement with Russia under section 123 of the United States Atomic Energy Act of 1954. This would not commit the United States to any specific project, nor would it reduce this country's leverage with nuclear partners in terms of licensing and possible legislation. It would, however, facilitate substantial new commercial opportunities for American companies, both within and outside the civilian nuclear industry. Without this agreement, the door is left wide open for European and Asian competitors, with potential spillover effects in manufacturing and other business sectors.

In the coming months, we will further maintain our communications with members of the new administration, and will continue to make recommendations regarding economic and business issues in US-Russian relations.



Andrew Somers is the President of the American Chamber of Commerce in Russia

A veteran's perspective

JIM BALASCHAK

A popular song chronicled the beginning of a new country and described a sense of optimism and hope for the Russian people several years ago:

Follow the Moskva, down to Gorky Park, and listen to the winds of change...

Many of us arrived in Moscow with similar dreams in the 1990's. At the time, one could feel the excitement and anticipation in the air. Today there is a different level excitement and anticipation: vibrant consumerism, coupled with a palpable fear of a financial meltdown.

I studied Russian for three years in the late 1980's with an eye towards potential business opportunities in Russia and the CIS, yet I never thought that I would spend fourteen years working in one of the world's most exciting markets, particularly during the transitional time following communism's collapse. We experienced daily, even hourly, the rapid shift to a market economy. The handover of an enormous stockpile of state assets to the private sector was the seminal event that eventually kick-started the free market we have today, impelling the economic revival of essentially a failed state. However, this "shock therapy," along with an unfreezing of Soviet-era price controls and continued privatization of the 1990's, also brought us to the brink of collapse in 1998. Shortly thereafter, soaring commodity prices and increased productivity provided a near decade-long boom. That cycle has now abruptly ended under a paralyzed global financial system.

So where do we go from here and how will we emerge from the pending malaise? Looking at the current financial crisis through the lens of twenty years involvement in the region, I will attempt to offer my own perspective.

In March 2000, as the Chairman of the American Chamber of Commerce in Russia, I gave an interview to *AmCham News*. Reading it today, I see how much has really changed and how much has stayed the same. The country has experienced unparalleled economic growth. Domestic demand and per capita income have nearly quadrupled during these eight years, and consumer spending now makes up a significant portion of GDP. There is now a productive middle class and significantly less dependency on the extraction industries to carry the economic burden. Russia, previously highly dependent on expensive imports of food and other necessary daily staple goods, now has sustainable internal capacity to meet most of its domestic demand.

How will the current economic situation affect this capacity? In recent months, near-term commodity prices have undergone a correction; yet continued world-population and economic growth should fuel a return to increased demand over the long term. The world will need, and Russia will continue to supply, extractive goods. Rampant government spending will need to be curtailed in the near term to offset projected export tax shortfalls and prevent a deterioration of the much-needed cash reserves. Under such a scenario, the ruble will most likely fall to levels required for the correction. However, unlike the U.S. and other OECD countries, Russia does not have the levers to manage the economy as precisely, for example, as does the U.S. Federal Reserve. But Russia continually demonstrates its resilience and resourcefulness. While it is once again in undiscovered and sometimes choppy waters, Russia will no doubt manage to muddle through.

Different times

The Moscow of 1994 was a desolate and desperate place. Petrol was dispensed via tank trucks by hose on Leningradsky Prospect. Metro entrances and *perekhods* were lined with hundreds of people selling their personal effects and treasures for a few rubles in order to eat. Average staff salaries were \$300 or less and, more often than not, paid in cash. It was difficult to find a ream of copying paper. Buildings were not lighted and streets were dark. Decent restaurants were scarce; in fact only ten western-style ones existed in Moscow, with American Express cards rarely accepted. Most coffee was instant, and much of that was counterfeit and not coffee at all, but bitter ground chicory. Yet...there were no traffic jams! And no eye pollution by billboards everywhere you look. How things have changed – sushi bars and coffee shops on every block – designer boutiques – health clubs. And while Wal-Mart has not ventured here yet, at least there are now a few Starbucks cafes. The restaurants have even become too

expensive for us frugal expats. Remember when TrenMos was “the” place? Nowadays we have the ubiquitous McNovikov’s.

How did that happen, given that in 2000, Russia was struggling to get its economy on track? How, in eight years, has Russia become the world’s eighth largest economy with a bustling consumer market? The genie is out of the bottle: The market economy has taken hold and the level of openness is a radical departure from decades past. These roots are very deeply planted.

Still, many problems remain that continue to drag and cause friction for the market: corruption, the lack of reform in the banking sector, a biased and inefficient judiciary, and an over-dependence on natural resources. While former-President Putin deserves kudos for progress in tax reform, his inchoate economic reforms never materialized.

One of the major disappointments of the past decade was that a country with such potential wasted an opportunity to meet expectations for change and to create an open civic society. Of course we Americans are impatient and expect things to happen tomorrow. Russia possesses some of the best assets in the world: the Russian people. Endowed by rich natural resources and a tradition in music and art, technology, engineering, and science, there is no limit to the future potential of the country. Financial jitters will pull in the reins in the short term, though not in the long term. But whatever future progress there will be will have to be determined by an administration willing to make the tough decisions that encourage private investment, both foreign and domestic; and these decisions will involve addressing the issues I mention above. Sadly, the government’s current measured response to the crisis has been to publically ignore it, or to blame it on the U.S., or not to allow the word ‘crisis’ to be used by official press channels. Meanwhile, the government attempts to manage currency valuation. But as we have seen, the market response to these steps has been brutal.

The eventual turnaround

The current cycle, as in 1998, will ferret out the weakest companies in a Darwinian “survival of the fittest.” The survivors will then have the potential for significant gains in market share. New-found efficiencies will eventually lead to even better performance when demand and growth inevitably return.

In the short term, we are witnessing knee-jerk responses – letting people go, cutting costs, maintaining profitability – in other words, an attitude of “let’s weather the storm and make our quarterly numbers.” However, an alternative approach by some savvy executives is to maintain organizational capability rather than downsize, accept short-term losses, and acquire new assets at bargain basement prices. Naturally, there will be winners and losers, but the game has more than one quarter. In Russia, you must think long term. Convince your colleagues at the home office that downturn is inevitable, but part of a cycle. Even during the writing of this article, there is speculation that U.S. markets may have bottomed out.

In retrospect, these past eight years have been very good to the majority of AmCham companies, allowing us to realize tremendous gains in both volume and profitability. Investments total tens of billions of dollars, if not hundreds. An annual growth rate of 30-percent- a-year was the absolute minimum.

The need for bilateral cooperation

AmCham has always been at the forefront of improving the business environment and providing support for American businesses. AmCham committees have played an integral and important role in shaping our strategy and focus. AmCham’s relationship with the U.S. government has been key. I have personally witnessed the tireless efforts of five U.S. Ambassadors, each of whom has understood the impact of the business environment in improving U.S.-Russia relations. We saw structural elements in the Gore-Chernomyrdin group and the U.S.-Russia Business Dialog as ways to assure continued, managed cooperation on the commercial agenda. The relationship of our leaders is paramount: Presidents Clinton and Yeltsin were on excellent terms; former Secretary of Commerce Don Evans and Minister German Gref met frequently and their friendship was genuine. Don visited Moscow in October 2001, just one short month after 9/11. By not cancelling his trip, he demonstrated confidence and continuity in the U.S.-Russia relationship. This meant a lot not only to us as Americans here on the ground, but also to the Russian people. I would expect that President Obama will establish his administration’s relationship with Russia through similar mechanisms and open dialogue.

Going forward, we need to decouple commercial and foreign policy issues. In 2001 AmCham and the U.S.-Russia Business Council urged the new Bush administration to use WTO as a framework for active commercial engagement. It is still on the table. A renewal of this effort by the new Russian and U.S. administrations, putting aside any discussion of sanctions, would be useful. Russia still has much to do in the agricultural, banking, and healthcare sectors, which can constitute an agenda for positive commercial engagement. Likewise, the Russian energy sector and infrastructure renewal will continue to require huge investments. Both of these topics warrant bilateral cooperation.

Political risk must be abated. In the 1990's there was tremendous political risk to doing business in Russia, mostly due to instability. The country risk premium was punitive. President Yeltsin can be remembered for fending off the Communists one final time in 1996. But it was close. President Putin brought long-needed stability and discipline to the government, demonstrating energy, sound decision-making, and ultimate authority – and a few good judo moves – eventually restoring national pride and commitment. The next eight or twelve years with President Medvedev present new challenges: continued integration into the global economy, economic diversification, NATO relations, and addressing the critical social needs of a declining population. Russia's legacy can be more than just oil. With its strong balance sheet, Russia has an opportunity to position itself for a very bright future.

What about the next twenty years? Nothing will surprise me. One of my greatest satisfactions has been to witness the growth and development of young Russian professionals in the Big Four to positions of significant responsibility - partners, CFO's, COO's, and CEO's, among others. These people, their value systems and resolve, will determine the future of Russia. They will demand transparency, openness, and a new order.

On a recent visit to my future home city of Philadelphia, I stopped by Independence Hall and reread a part of the Declaration of Independence. I was struck by the phrase in particular that we, as Americans, hold certain values “to be self-evident.” It is my belief that Russians are coming to see these principles in the same way too.



Jim Balaschak is the former Chairman of AmCham and Senior Partner in Clients & Markets at Deloitte in Moscow.

Today's Russian economy

CHRIS WEAVER

As elsewhere in the world, conditions in the Russian economy are deteriorating and will get worse before stabilizing, hopefully, in the third or fourth quarter of next year.

Although the outlook for the start of the year is bad, the case is improving for a much more favorable investment backdrop in the second half: The massive amount of liquidity that governments around the world are pumping into their economies and the measures being taken to prevent a prolonged recession should have a positive impact in the second half of 2009. That, plus output cuts that materials and commodities producers are making, should produce a real inflationary boost to economies and commodity prices later in the year.

It is important to remember that Russia has enough financial resources to weather the economic storm over the winter months, and the country is also sufficiently adaptable to withstand a long period of global downturn. The fact that the economy has not yet achieved any real trade or investment integration with the rest of the world can be a virtue in such periods.

The basic investment case for Russia – the reason to buy assets – is that the country will survive this financial and economic crisis. No major bank will fail and no major corporation will default on its debt.

The big hope is that the Russian government will treat the crisis as a wake-up call and place greater emphasis on reforms once the dust has settled. To maintain the government's aim of increasing investment in the country and ensuring greater economic diversity, Russia will need to attract greater inflows of foreign investment. This can only be done with a much improved business climate and business practices. The pace of reform has moved far too slowly so far, but will hopefully pick up in 2009. Reform of the financial markets can now be included in the list of much needed, and now obvious, reforms.

Main Domestic Assumptions for 2009

Default risk: There is zero risk of a sovereign default or a default by any state-owned/controlled company, and very low risk of a technical default from any major enterprise. The main risk lies with ruble issues of smaller companies; we expect some technical defaults at least.

Banks: No major bank will fail, but the share of non-performing loans will increase significantly. Bad debt write-offs will inevitably increase.

Economic growth: GDP growth will continue to fall through the first and second quarters of 2009. This will entail further job losses and company closures. Macroeconomic news flow is likely to be at its worst in late first quarter and early second quarter. But as commodity prices rally in the second half of 2009 and confidence rebuilds, we expect the economy to improve.

Consumers: The economic crisis spells the end, for a time, to consumption growth in Russia and by Russians in foreign markets.

Real estate: The price of real estate, both commercial and residential, will fall a lot more than already seen. The market will likely reach a bottom in the second or third quarter.

Inflation: The government will not achieve single-digit inflation in 2009 given the massive liquidity injection into the economy. The prospects for inflation much below 10 percent in 2010 are not very promising either.

Oil production: We expect a production decline of at least 2 percent in 2009, with a drop of up to 5 percent also possible. This would mean a loss of production and exports of between 200,000 and 500,000 bpd by the end of the year. The lower production will be due to large cuts in oilfield spending by the oil majors, prompted by lower cash flows, a lower oil price, and high taxes.

M&A: We anticipate a surge in mergers and acquisitions in 2009 as companies and investors with cash use the opportunity to acquire assets from financially strapped owners. Industry consolidation is already underway in the banking sector and is expected in the consumer and other sectors. Many companies will have to combine in order to survive.

Main Risks for 2009

Global growth: If the financial packages being put in place in the U.S. and elsewhere do not stop the global economy from slipping into a deeper, longer recession, the hoped-for bounce in commodity prices will be delayed. This would also have a negative impact on the domestic economy and pull growth lower, which would also mean more job losses and business closures than currently anticipated.

The domestic economy: If the oil price retraces to the long-run average and holds there for the first half of 2009, then the decline in the rate of GDP growth will be much worse. If, additionally, the problem of a shortage of bank finance and end-user confidence is not resolved early in the year, then the slowdown will worsen in the broader economy, leading to large scale job losses and a very steep recession.

Oil and the ruble. If global economic growth drops by more than expected and/or OPEC does not match lower demand with further production cuts, the price of crude will fall closer to the long-run average of \$30/bbl. In this event, it is unlikely that Russia will have enough financial reserves, or indeed be willing to burn them at a faster pace, making devaluation inevitable.

An oil spike: A spike cannot be ruled out. This would of course require a supply shock, such as an attack against Iran and Iran's retaliation, or a major conflict in Nigeria. Right now the prospects are low, but they cannot be completely ignored.

Political instability: If the ruble undergoes a devaluation and, at the same time, the economy slips into recession with more widespread job losses and company failures, this would be reflected in an inevitable collapse in public confidence in the government.

China: A sharp drop in Chinese growth would hit the prospects for a rally in commodities, and in Asian economies, through the second half and would push prices much lower in the interim. The risk of social instability would also rise, which would delay any recovery in both China and in commodity-dominated countries such as Russia.

Corporate governance: We have already witnessed a deterioration in corporate-governance standards, which is affecting how investors view Russian risk. If this trend continues and minority investors' interests are harmed, the investment risk premium will rise further.

Sector Themes for 2009

Main themes: The backdrop of a slowing economy and generally weak commodity prices will of course provide the main investment theme through at least the first half of 2009. The other main themes include:

Ruble weakness against the dollar and euro: This factor will increase the value of export earnings for industries such as oil, gas, and other commodities. It will also increase the cost of servicing foreign debt and the cost of imported goods. That, in turn, may help companies competing against imported goods, such as food manufacturers.

Cost reduction: Industries with a high-cost content in materials, such as cement, coal, pipes, and steel, will see a big drop in costs in 2009. We are already seeing evidence of this and it will become much more apparent in the costs of oil companies, for example, in the first half of 2009.

Consolidation: Already evident in the banking and financial sectors, we may see more acquisitions and mergers across other industries, such as the retail sector.

Regional variations. Regions dominated by one large industry will be more obviously affected by the slowdown than other regions that either are dependent on federal budget support or have a more diversified economy.

Consumer industries: Russia's retailers are facing a much tougher first half in 2009, with the already evident slowing in spending expected to get much worse. The trend will be towards lower priced goods, particularly in food retailing, with discounters expected to outperform the higher priced outlets.

Utilities: The main risks to the sector come from reduced electricity demand as the economy slows and an expected drop in deregulated wholesale prices. We expect the distribution companies to face a tough environment because of a likely drop in connection fees.

Banking: The big challenge facing all banks in 2009 will be the rising level of non-performing loans and bad debts. The creditworthiness of corporations and individuals will worsen as the economy slows and unemployment rises. Industry consolidation will step up apace, as the stronger banks take out the weaker, troubled banks.

Manufacturing: This sector is heading for a major downturn with industries such as auto manufacturers already announcing production and staff cuts. This is a late-recovering sector.

Metals and mining: The industry is suffering from a lack of demand, falling prices, rising bad debts and limited access to trade finance. Most companies will report very bad first-half results. The major hope is for a recovery in the second half, if demand picks up a little, though against a backdrop of reduced supply, as producers continue to scale back capacity in the first quarter. Gold is expected to be preferred as a safe haven play (and silver to a lesser extent); and that will be positive for sentiment towards the gold producers.

Oil and gas: Costs are beginning to fall across the industry, as the price of materials such as cement drops. This should provide a more positive backdrop for the second half of 2009. Longer-term drivers include diversification into the more profitable retail segment and the use of new technologies. The big question mark, apart from the oil price, is oil taxation, with the industry continuing to lobby for bigger cuts and the Finance Ministry opposing it.

Real estate: If history repeats itself (in line with other economic slowdowns, such as Asia in 1997-1999), then this will be the last sector to recover.

Telecoms: The mobile telecom stocks are relatively well-positioned in a slowing economy, as the bulk of their revenue is for basic services. The example from other countries that have entered a slowdown earlier than Russia is that basic mobile activity holds up relatively well.

Transportation: This is one of the most exposed industries to slowing disposable income and business activity. Considerable downside risk exists.



Chris Weafer is chief strategist at Uralsib Capital, LLC in Moscow.

The Impact of the Strategic Sector Law - Six Months Later

The strategic sectors law has been welcomed by international businesses in Russia as a move to bring greater clarity for foreign investors. But has the law gone too far in restricting investment in key Russian industries.

LAURA M. BRANK AND DARIA LITVINOVA

Last May, on the day Mr. Medvedev was inaugurated into office as President of the Russian Federation (RF), the long-anticipated "Law on Foreign Investment in Companies with Strategic Significance for National Security and Defense" (the "Strategic Sectors Law") and Federal Law No. 58- FZ amending certain other Russian laws to give effect to the Strategic Sectors Law (the "Amendments Law") came into effect. The Strategic Sectors Law sets forth restrictions on foreign investment in certain sectors that the Russian government considers to be of strategic importance to national security and defense.

In total, forty-two sectors are covered by the Strategic Sectors Law, making the list longer and broader than anticipated. Its impact on investment in Russia is significant. In the nine months since the law was adopted, numerous deals have been put on hold, and, as of this writing (February 5, 2009), only a handful of investments have been formally approved by a newly-formed commission, while confusion over the application of the new law on subsoil companies has led to a general sense of concern among investors in the subsoil area.

The purpose of this article is to describe and analyze the provisions of the Strategic Sectors Law and the Amendments Law and to provide an update on the application of these laws.

Strategic (and strategic subsoil) companies covered by the law

The Strategic Sectors Law lists the forty-two sectors that the Russian government considers to be of strategic importance. These include the use and construction of nuclear facilities, media-related activities such as television and radio broadcasting to more than half of Russia's population, "large-scale" printing or publications with a circulation of more than one million, activities relating to aviation and aircraft safety, fisheries, industries registered as a natural monopoly (with certain exceptions), and geological exploration and extraction of natural resources from subsoil plots of "federal significance", among others. Any company engaged in any listed activity is deemed to be a strategic company.

The greatest impact of the law thus far has been on subsoil companies. A strategic subsoil company is defined as a strategic company engaged in activities on subsoil plots considered to be of "federal significance." As defined by the Strategic Sectors Law, subsoil plots of federal significance include those:

- Containing deposits of uranium, diamonds, quartz of very high purity, rare-earth minerals of the yttrium group, nickel, cobalt, tantalum, niobium, beryllium, lithium, or metals of the platinum group
- Containing (according to information on the state balance of mineral reserves, commencing January 1, 2006):
 - Recoverable reserves of oil of 70 million tons or more
 - Reserves of gas of 50 billion cubic meters or more
 - Vein gold reserves of 50 tons or more
 - Copper reserves of 500 thousand tons or more
- Lying within any inland sea waters, territorial sea waters, or the continental shelf of the Russian Federation, or
- Situated in subsoil areas where the land is used for defense and security purposes.

Definition of foreign investor under the law

The Strategic Sectors Law applies to foreign investors, defined as any non-resident of Russia who is capable of investing under the laws of the jurisdiction in which it is a resident and includes entities, individuals, states and/or

international organizations, as well as any company established in the Russian Federation operating under the "control" of foreign investor(s). The Strategic Sectors Law applies to proposed transactions that would result in a foreign investor controlling, directly or indirectly, a strategic company.

A foreign investor will be deemed to "control" (directly or indirectly) a strategic company if it has the right, in respect of the management of the strategic company, to appoint the sole executive body of the company, to form or engage a management company, to oversee the functions of the executive body, or to otherwise determine the decisions and business activity of the company. Furthermore, a foreign investor will be deemed to "control" a strategic company if it has the right, with respect to the equity of a strategic company, to dispose of more than 50 percent of the voting shares of the company (or less than 50 percent of the voting shares, if the distribution of votes enables such foreign investor to determine the decisions of the company), appoint more than 50 percent of the collective executive body, or elect more than 50 percent of the board of directors or other managing body of the company.

A lower control threshold applies to strategic subsoil companies. A foreign investor will be deemed to control a strategic subsoil company if it has the right to dispose of 10 percent or more of the voting shares of a strategic company, appoint 10 percent or more of the collective executive body, or elect 10 percent or more of the board of directors or other managing body of the company.

The implications of this provision of the law are major, given the number of Russian companies that are structured using foreign offshore holding companies. Accordingly, not only purely foreign entities will be affected, but also major Russian companies owned by Russian shareholders via offshore holding vehicles, which affects many of Russia's large mining companies. The consequence, as described below, is that Prime Minister Vladimir Putin, as head of the Commission (defined below), essentially has the last word on whether an investor will be allowed to acquire a stake in or increase its stake in a strategic company.

Transactions covered by the strategic sectors law/approval process

Any transaction (including offshore transactions) that would result in a foreign investor controlling (based on the criteria set out above) a strategic (or strategic subsoil) company will require the prior approval of the Government Commission for Control over Foreign Investment in Russia (the "Commission"). The Commission was established on June 2, 2008, and is chaired by Prime Minister Putin.

Failure to acquire prior approval of the Commission or a breach of any condition attached to approval may result in the transaction being unwound. Courts could impose other restrictions, including limitations on voting rights of the foreign investor in the strategic company.

A transaction will not require prior approval from the Commission if the foreign investor has already gained the right to dispose of more than 50 percent of the voting shares of a strategic company (other than a strategic subsoil company) and, in respect of a transaction relating to a strategic subsoil company, if the Russian government has the right to dispose of more than 50 percent of the voting shares of such a company.

Grandfathering

The Strategic Sectors Law generally does not apply to transactions concluded before May 7, 2008. However, any foreign investor which held, on May 7, an interest (direct or indirect) of more than 5 percent of the voting shares or participation interest in a strategic company was required to notify the Federal Antimonopoly Service (FAS) of such interest by November 7, 2008.

Implications for foreign investors with interests in strategic subsoil companies

As noted above, the most severe restrictions are imposed on foreign investment in strategic subsoil companies. For example, foreigners may be prohibited entirely from participating in tenders and auctions for the right to use certain subsoil plots of federal significance. In addition, foreign investors who hold combined licenses (covering exploration and mining) may be forced to relinquish their rights to the mining license if they discover a mineral deposit on a subsoil plot of federal significance after May 7, 2008, except, presumably, where mining had begun under such combined license prior to May 7, 2008. This particular provision of the law has caused great concern among mining and oil companies. Without the potential benefits generated by a potential discovery, the law creates a major

disincentive to invest in exploration in Russia. Given the fact that many of the new oil and natural resource discoveries in Russia may be located in geologically challenging areas, such a disincentive could lead to a serious lack of necessary investment in the Russian oil-and-gas and precious metals sectors.

Application of the Law

Resolutions

Since the law came into effect, several resolutions of the RF government have been issued seeking to clarify certain provisions of the law or establish the necessary institutions and procedures for compliance with the law. Most recently, Resolution No 697 was issued on October 7, 2008 to clarify the procedures for terminating the right to use a strategic deposit discovered during a geological survey performed under a combined license. Unfortunately, this resolution failed to clarify the type of compensation an investor would be entitled to if a license is terminated following a discovery of a strategic deposit. The law provides that an investor has the right to compensation of geological expenses, the return of the license fee, and possibly a finder's fee, but the amount and calculation of the finder's fee is still unclear.

On November 7, 2008, Resolution No. 823 was issued establishing the procedure for official publication of the list of strategic deposits by Rosnedra in Rossiyskaya Gazeta, but as of this writing, the list has yet to be published.

On November 27, 2008 Resolution No. 897 was issued to clarify the procedures for a subsoil user, who discovered a strategic deposit while conducting geological survey under exploration license, to obtain a mining license. Similar to Resolution No. 697, Resolution 897 set forth the steps for the state authorities to consider the possibility for a subsoil user to further develop the discovered strategic deposit. However, again Resolution No. 897 failed to clarify the type of compensation an investor would be entitled to, if a mining license is not granted.

On January 8, 2009 Resolution No. 4 was issued establishing the procedure for issuing mining and combined licenses to develop strategic deposits without holding a tender or auction. The procedures established by Resolution No. 4 apply to deposits located on the Russian continental shelf, strategic deposits located within the territory of Russia and spreading out to its continental shelf and also strategic deposits containing gas.

Approvals Granted

To date, the Commission appears to have approved five applications; one application appears to have been put on hold. The first application was in connection with World's Wing S.A.'s acquisition of a 25-percent-plus-one share interest in CJSC Grazhdanskiye Samolety Sukhovo. The lower threshold approval was required due to the fact that World's Wing is owned by a foreign government. The transaction was approved by the Commission on August 10, 2008. Mr. Putin used this opportunity to announce that strategic sectors are not closed to foreign investors, but this transaction could hardly be considered one in which there could possibly have been a threat to Russia's national security or defense.

A second transaction involved the purchase by Archangel Diamond Investment (a subsidiary of DeBeers) of 49.99 percent of the shares in the diamond mining company OJSC Arkhangelsgeologodobycha, which is controlled by LUKoil. Under the conditions of approval, DeBeers was required to process rough diamonds in Russia in certain amounts to be agreed with the RF government and was obligated to comply with certain other requirements. This decision also seemed politically motivated given the long standing dispute between LUKoil and DeBeers over the Verkhotinskaya Diamond field. However, DeBeers appears to have cancelled the acquisition due to an apparent unwillingness to meet the requirements imposed by the approval with respect to the terms of sale of diamonds.

On February 4, 2009, the Commission appears to have granted three more approvals.

As the government press-service reported, OJSC Hartron, a company controlled by the Ukrainian Government, apparently was allowed to acquire part of an additional share issuance in International Space Company CJSC Kosmotras. As a result, the shareholding of OJSC Hartron will increase to 49.74 percent. The press-service clarified that the company is engaged in military rocketry disposal activities.

According to the same press report, Barrick Gold Limited, controlled by Barrick Gold (Canada) was apparently

allowed to acquire 30 percent of the additional shares in CJSC Fedorovo Resourcing, thereby increasing its share from 50% to 80%.

Universal Cargo Logistic Holding B.V. (Cyprus, Beneficiary: Mr. V.S. Lisin) apparently was allowed to acquire 100 percent of the shares in OJSC Taganrog Overhaul Factory (Taganrogsky Remontny Zavod).

The specific terms of the three approvals are unclear at the time of this writing as they were only announced on February 4, 2009.

On the same date, the Commission also was supposed to consider the application of TNK BP to increase its shareholding in OJSC Verkhnechonskneftegaz from 68.5% to 73.98%. However, the application was apparently put on hold until the next meeting of the Commission (the date of which has not been announced yet).

Given that only five approvals have been granted in nine months and the details of the most recent approvals have not been released, it is still too early to determine in practice what standards the commission will generally use in applying the law to a given transaction.

Conclusion

The Strategic Sectors Law finally clarifies those sectors that will be considered strategic to the Russian government, and this is an important step in making the limitations on foreign investment in Russia more transparent. However, it covers a wide range of sectors, and the restrictions on the subsoil sector are too severe, making it very difficult and time-consuming to transfer assets in this sector. The restrictions also discourage investment in an area that will require western technology and resources. Additionally, in drafting a law without concurrently creating the necessary institutions, the Russian government has strained the flow of investment into Russia while investors await further clarity. After so many years of deliberation by the government, it is disappointing that the Strategic Sectors Law contains so many ambiguities. The fear, of course, is that these ambiguities allow the government too much discretion in rejecting foreign ownership, which has already become evident in a recent decision involving TGK-4. Foreign investors need certainty when investing in a country. Given these turbulent economic times, the Russian government needs more than ever to demonstrate that foreign investors are welcome and will be treated fairly.



Laura M. Brank (on left) is a Partner with the law firm Chadbourne & Parke LLP in Moscow. Daria Litvinova is an Associate with the firm.

Russia in America: The CFIUS effect

MARK E. PLOTKIN AND DAVID N. FAGAN

Over the last several years, Russian outward investment has been on a sharp upward trajectory, rising from approximately \$10 billion in 2003 to \$45.7 billion in 2007. While the pace of this investment has been affected by recent market turmoil and the global economic downturn, the underlying forces behind the investment likely will remain and gain in strength as the recession eases. These include domestic natural resources that create competitive advantages in metallurgy and energy (two principal sectors of outward investment), as well as a desire to diversify economic positions by geography as a method to hedge against Russia's more unpredictable domestic economy and political environment.

The U.S. government has estimated that the U.S. receives roughly 40 percent of this outward investment flow from Russia, with much of the investment coming from Russian steel and other alloy companies. Following the Russian-Georgian conflict from last summer and in the wake of Gazprom's most recent shut-down of natural gas exports to Eastern Europe, this volume of investment from Russia raises a significant question for the United States:

Does the United States have appropriate mechanisms to encourage positive investment from Russia that will result in economic benefits to the U.S. while still thoroughly scrutinizing investments that could implicate U.S. national security interests? As a result of the recent legislative and regulatory strengthening of the national security review process undertaken by the Committee on Foreign Investment in the United States ("CFIUS"), the answer to this question is "yes."

In December, the U.S. Department of Treasury, as chair of CFIUS, issued the Committee's final regulations formally implementing the Foreign Investment and National Security Act of 2007 ("FINSA"), which amended section 721 of the Defense Production Act of 1950 (often known as the "Exon-Florio Act"). The final regulations reflect a balance of the various CFIUS agencies' interests and provide flexibility for CFIUS to review transactions that are likely to raise real or perceived national security risks, while also maintaining a process that is narrowly focused on national security and consistent with an overall policy of promoting foreign investment.

As described below, together with FINSA and President Bush's implementing Executive Order from January, these regulations should instill faith both in Russian investors (as well as investors from all other markets) that they will receive a fair shake in the regulatory review and in Members of Congress and other observers that CFIUS is legally empowered to, and in practice does, carefully examine investments and act to ensure the U.S. national security.

CFIUS in Practice

Certain fundamental aspects of the amended CFIUS structure ensure that it can carefully scrutinize Russian transactions and that Russian investors can have confidence in a fair and timely outcome.

First, the law and final regulations provide CFIUS with broad discretion to determine that a particular foreign investment in a U.S. business is "controlling" — and, therefore, the transaction is a "covered transaction" subject to CFIUS's authority. In the final regulations, CFIUS emphasized that its approach to the "control" determination "eschews bright lines" and, instead, remains a functional test that evaluates on a case-by-case basis whether the foreign entity has the practical authority "determine, direct, or decide important matters" affecting the U.S. business.

Second, the law's approach to national security is equally flexible. The statute does not define "national security," but instead provides a non-exhaustive list of factors that CFIUS may consider in assessing whether a transaction poses a national security risk. These include, for example, the transaction's potential effects on the ability of domestic industries to meet national defense requirements; potential effects on U.S. critical infrastructure; whether the transaction involves foreign government control; and the relevant foreign country's record of cooperation with U.S. counter-terrorism efforts.

In public guidance issued in connection with the final regulation, CFIUS explained how it relies upon these and other factors to determine whether a transaction presents any national security risk. Considering the facts and

circumstances of the transaction, CFIUS determines the threat and vulnerability presented by each transaction. This analysis is informed by an intelligence assessment from the Director of National Intelligence, as well as a review of the statutory factors and, on a case-by-case basis, other criteria. The threat assessment considers whether the foreign person has the capability or intent to cause harm, and the vulnerability assessment considers whether the nature of the U.S. business, or its relation to certain systems, structures or other entities, creates a susceptibility that U.S. national security may be impaired. The national security risk determination is “a function of the interaction between threat and vulnerability, and the consequences of that interaction for U.S. national security.”

These broad approaches to the control determination and national security test provide CFIUS an appropriate ability to examine transactions that truly threaten national security interest because of the presence of foreign control. At the same time, they appropriately do not capture all foreign investments.

Third, while CFIUS has authority to initiate its own reviews of covered transactions, the CFIUS review remains an inherently voluntary process, affording parties with discretion on when and whether to notify CFIUS of an investment in a U.S. business by a foreign person. This important procedural component preserves a policy of openness to foreign investment. CFIUS could not possibly review all foreign investments within a reasonable amount of time, nor should it — the overwhelming majority of transactions do not implicate any national security concern. (For those transactions that are subject to CFIUS’s review, the maximum 90-day timeframe for the CFIUS process also is vital to ensure the process does not unreasonably interfere with deal flows.)

At the same time, the statute and regulations create incentives for parties to file with CFIUS even if the relation between the transaction and U.S. national security interests may be tangential at best. CFIUS monitors merger and acquisition activity, and, as noted, has the authority to compel parties to file for a CFIUS review. From the transaction parties’ perspective, it is always preferable to voluntarily raise a transaction with CFIUS rather than to have CFIUS formally come calling after the transaction is announced. Moreover, while relatively few covered transactions raise potential national security concerns, the President and CFIUS have the power, without any statute of limitations, to unwind a transaction after closing — which is the ultimate power over any transaction. Conversely, a CFIUS review and approval provides a form of safe harbor for a transaction that can be revisited only in very limited, exceptional circumstances.

Fourth, for those transactions that present a potential national security risk, the statute and regulations codify the concept of risk-mitigation, which has long been an element of the CFIUS process. Specifically, if a member agency of CFIUS identifies a national security risk, it may set forth certain proposed mitigation measures that the agency believes are reasonably necessary to address the risk. If CFIUS as a committee agrees with the proposed mitigation — and if provisions of other laws do not adequately address the risk — it may then negotiate and reach a formal agreement with the transaction parties to impose the mitigation measures as a condition of CFIUS approval. These mitigation agreements are subject to the penalties in the statute, including the full Presidential authority to unwind the transaction if the mitigation agreement is materially breached. The final regulations also provide for monetary fines, including up to the full value of a transaction, for intentional or grossly negligent breaches of mitigation agreements.

Fifth, the statute directs CFIUS to report to Congress on transactions on a post-review basis. Thus, the statute defines a proper oversight role for Congress, while leaving the national security analysis up to the professional members of the CFIUS agencies. For investors from emerging markets like Russia, this post-review information flow to Congress is a particularly important dynamic to gain some degree of comfort that the political environment, while not entirely risk-free, may be less primed for another Dubai Ports World-type shock.

Russia’s Experience Under CFIUS

The experience of Russian investments to date suggests that Russian companies and their counsel understand the potential benefits of undergoing a CFIUS review, and that CFIUS in turn is examining these investments closely. The Russian steel producers Evraz Group and OAO Severstal, which have been the most frequent investors in the United States, and the nickel company Norilsk Nickel, among others, have voluntarily submitted transactions to CFIUS for review. These have included transactions that, at the time, were the largest Russian investments in the United States.

CFIUS has probed these transactions deeply. This scrutiny has included examining, among other things, the ownership structure and transparency of the Russian companies, the extent to which the Russian companies were

acting on the personal backgrounds as well as legal compliance and commercial conduct of the executives and directors within the Russian companies, and the general compliance record of the Russian companies in the United States and abroad. In each instance, CFIUS also would have weighed the acquisition's effect on sources of supply for the U.S. government; assessed whether any sensitive technology transfer could have been involved; and considered whether there were other existing competitors in the U.S. market. The result of this analysis has been a record of approval for these Russian investments, enabling the transactions to proceed. In turn, these Russian companies have, for the most part, created a strong record of maintaining and increasing U.S. manufacturing facilities and jobs.

CFIUS is also well positioned to review any material changes in ownership structure to these Russian companies. This is potentially important because, while the Economist Intelligence Unit has concluded that "commercial motives appear to predominate" Russian outward investment, there also have been recent news reports about the Kremlin's interest in reclaiming certain domestic industries, including natural resources companies such as Norilsk Nickel. Any material change in the foreign ownership structure of a company that has undergone CFIUS review would clearly be subject to CFIUS's authority with respect to the U.S. business assets owned by the company. Where that ownership change involves increased stakes by a foreign government, FINSAs creates a presumption that the transaction will receive enhanced scrutiny in the form of an additional 45-day investigation following the initial 30-day review.

As CFIUS has emphasized, the fact that a business is controlled by a foreign government does not necessarily mean that the transaction poses a national security risk. CFIUS still considers all of the facts and circumstances relevant to national security in assessing whether the foreign person has the capability and intent to use its control of the U.S. business to impair U.S. national security. However, if the Russian government gained control over Russian companies that own U.S. businesses, CFIUS would almost certainly examine the impact of the change in ownership structure upon the Russian firm's investment management policies and the degree to which, in practice, the firm's management and investment decisions could be exercised independently from the Russian government. Combined with a re-evaluation of the U.S. assets in light of the change in ownership structure, these factors could lead CFIUS to a determination on the national security risk posed by the Russian investment different from its original approval. In such circumstances, CFIUS would have the full authority under the statute to take appropriate action to mitigate the risk or even unwind the investment.

Accordingly, CFIUS is well positioned both to evaluate and permit Russian investments that occur on commercial grounds and do not present national security risks as well as to address any future changes in Russian domestic circumstances that could introduce Russian government ownership into businesses that have significant investments in the United States. In this way, FINSAs and the implementing regulations from CFIUS should provide all interested parties with the confidence that the United States regulatory framework can fairly and appropriately address the potential benefits and challenges of Russian investment.



Mark E. Plotkin (on left) is a Partner with the law firm Covington & Burling LLP in Washington, DC. David N. Fagan is an Associate with the firm.