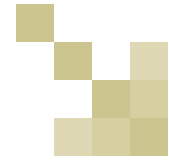


Russian Federation

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MARKET

1. Please describe briefly the venture capital market in your jurisdiction, in particular:

- How it is distinguished from private equity.
- The sources from which early stage companies obtain funding.
- The types of companies that attract venture capital investment.
- Market trends (for example, levels of investment, the type of companies invested in and where those companies are located).

Venture capital and private equity

Notwithstanding sufficient reforms in corporate governance, there is still a lack of special regulation aimed at investments generally, including venture capital and private equity. Laws regulating investments are outdated and practically of no use, the effective legal definition of a private equity transaction is far from accepted standards and venture capital is not defined at all. Reforms were proposed in the Bill on Innovations and State Innovation Policy which was tabled to the State Duma in 1999. However, it was sent back by the government in 2001 for further modification and was never tabled again.

The Law on Investment Funds (*No 156-FZ, 29 November 2001*) provides regulation for mutual investment funds and incorporated investment funds organised in Russia. It severely restricts those funds' activities, often making them unsuitable for venture financing.

The Federal Service for Financial Markets (FSFM) (the body which controls and supervises activity in the financial markets in the Russian Federation) has defined venture financing as investments in high-technology or similar companies connected with significant risks for investors. However, this definition in itself does not provide a clear distinction between venture capital and private equity.

Therefore, there is no significant legal regulation of venture capital and venture funds and it is impossible from the legal point of view to clearly distinguish venture capital from private equity, especially as venture financing is usually provided in form of a private equity transaction. This lack of regulation significantly complicates venture capital activities in Russia, although does not make it totally impossible.

Sources of funding

Venture capital has a short history in Russia compared to western countries, and its early development is strongly connected with international financial institutes, such as the European Bank for Reconstruction and Development or the International Finance Corporation. For several years venture funds organised by these institutions were the sole source of special purpose venture financing, until other foreign and local venture investors emerged. The first foreign venture capital funds' activities were supported by foreign state agencies and committees (for example, the Overseas Private Investment Corporation, a US state agency). Venture capital funds of international and foreign origin are still one of the main sources of venture financing in Russia and the number of local venture investors remains low.

Investment funds organised under Russian investment legislation, including mutual investment funds and incorporated invested funds, often cannot provide sufficient venture financing, due to restrictions provided by legislation and their internal regulations. Pension funds have also not become large investors as they face similar restrictions to investment funds. However, potentially they all are able to provide financing for venture companies.

The state can invest in the national economy through specially created state investment funds, which are another source of venture funding. In 2000 a state Venture Investment Fund was established. Later, the Russian Venture Company (RVC) received substantial financing from the state to distribute between ten to 20 venture funds. The RVC is modelled on the Israeli Jozma programme as a fund of funds providing financing to private funds on a 50/50 basis.

Types of company

Most companies attracting venture financing are small- or medium-sized companies engaged in innovative, high-tech research and production, such as IT companies or telecommunication companies. They are usually early-stage companies offering or intended to offer new products and services.

The company may be organised as either a limited liability company (LLC) or a joint stock company (JSC). Depending on the form of the company, the investor may receive participatory interest or shares in the company, both representing its stake in the company, but having slightly different legal regimes (*see Question 18*).

Market trends

Investments in venture capital represent an insignificant part of total investments made in Russia. The most popular spheres of venture financing are information technology, especially software, and telecommunications. Companies planning to produce goods are less popular.

There are a number of problems currently slowing development of the venture capital market in Russia, including:

- Lack of specific legal regulation.
- Underdevelopment of infrastructure, hindering the development of small- and middle-sized research and development companies.
- An underdeveloped and unstable securities market which results in a low liquidity of venture investments.
- Lack of competent management in the sphere of venture investment.

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

There are no special tax incentive schemes to encourage investment in venture capital, which is another serious barrier to its development. Generally, the tax aspects of investment are under regulated. However, the Tax Code can provide some benefits to the parties of an investment transaction as shown below.

Income tax

Income received from contributions to a company's charter capital or within the framework of target financing need not be considered when calculating a tax base in respect of income tax (*article 251, Tax Code*). Therefore, investments in a target venture company are not taxed if they come from either direct financing or contributions to its charter capital from its shareholder(s), including holding companies.

Investment tax credit

The investment tax credit provides a time period when the target company may (within certain limits) decrease its payments on certain taxes, gradually repaying this debt and accrued interest in the future (*article 66, Tax Code*). To apply for an investment tax credit the company must meet one of the following requirements:

- The company must be involved in research and development or technical upgrading to its own production (for example, upgrades aimed at employment of disabled persons or environmental protection).
- The company must commission or itself be involved in:
 - innovative activities;
 - creating or upgrading technologies;
 - developing new sources of raw materials.
- The company must provide an important contribution to the social and economic development of a region or provide important services to the general public.

Double taxation treaties

Russia has double taxation treaties with many countries, providing possible tax benefits for foreign investors. Local investors can

also enjoy these benefits by including a company organised under the law of one of these countries into the structure of the investment transaction. This is an important consideration as the overwhelming majority of venture investors acting in Russia use structures and instruments based on foreign law.

3. From what sources do venture capital funds typically receive funding?

The first venture capital funds were organised and fully funded by international organisations. Later a number of private foreign funds were established. Local financing still has a small part in the amount of overall investments.

While private foreign financing, local financing or a combination of the two is usual, state financing (both on federal and regional levels) is also available and is becoming increasingly popular (see *Question 1, Sources of funding*).

4. Can the structure of the venture capital fund impact on how investments are made?

Funds with different structures, sources of financing and management have different views on acceptable investment targets, the way the investments are made and exit structuring. In particular, Russian-based investment funds usually have more limited means of making investments and less to invest compared to foreign funds, although the targets of investments are mostly the same. Foreign investment funds, having more complicated structures, higher funding and much greater experience currently have a big advantage over the local funds which is expressed in the level of investment and rates of return.

5. Do venture capital funds typically invest with other funds?

In practice, venture funds mostly invest independently and without the participation of other funds. This is because venture financing in Russia is mainly done by large foreign funds able to provide the necessary finance. However joint financing with other funds or strategic investors is possible. It is more common when attracting a new investor on a later stage on the next round of investments.

FUND FORMATION AND REGULATION

6. What legal structure(s) are most commonly used as vehicles for venture capital funds in your jurisdiction?

The company may be organised as either a limited liability company (LLC) or a joint stock company (JSC). As there is currently no distinction of legal form between public and private companies, the choice of structure does not dramatically affect the way investments are made.

Another option is to use a mutual fund. Mutual funds are regulated by the FSFM and are obligatory for managing state funds.

7. Do a venture capital fund's promoter, manager and principals require licences?

Licences may be required in limited situations, including:

- Some professional participants of the stock market, including brokers, dealers and depositaries must obtain special licenses. However, in most cases funds do not operate on stock markets on their own, so neither the fund nor its promoter, manager or principals require a licence.
- Russian-based mutual and incorporated investment funds investing in venture companies require a license for securities management. Certain requirements also apply to their management team.

8. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions? Include, in the answer, any restrictions on how a venture capital fund can be marketed or advertised (for example, under private placement or prospectus rules).

As venture funds are not specifically regulated (see Question 1) they follow the general rules provided for companies making investments. Fund vehicles follow general corporate legislation including all restrictions provided for Russian companies by advertisement, marketing, securities and anti-monopoly regulations. For example, advertising restrictions on Russian-based mutual investment funds and incorporated investment funds include:

- Restrictions connected with sources of funding, investment instruments and other restrictions, provided mainly by acts of the FSFM.
- Advertising regulations provided by article 28 of the Law on Advertising (*No 38-FZ, 13 March 2006*) which aim to ensure the full and accurate disclosure of information about the fund and its activities.

These requirements may be applied to all investment funds acting in Russia.

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

For foreign venture funds acting in Russia, relations between investor and fund are governed by the law of the jurisdiction where the fund is established. Therefore, they can invest in Russian target companies without any changes to the relationship.

For domestic mutual and incorporated investment funds, relations are regulated by:

- The Law on Investment Funds.
- Acts of the FSFM.

- If an incorporated investment fund, the fund's charter and investment declaration.
- The rules on trust management for mutual investment funds.

Since incorporated investment funds must be JSCs under Russian law, their investors are their shareholders. They can therefore participate in the fund's management and protect their interests in this way.

The rules on trust management for mutual investment funds are intended to provide investors with substantial protection through extensive responsibility and accountability obligations for the fund's managing company.

10. What are the most common investment objectives of venture capital funds (for example, what is the average life of a fund, what return will a fund be looking for on its investments and what is the time frame within which a fund would seek to exit its investment)?

Foreign venture capital funds operating in Russia aim to invest in start-up projects and early-stage companies with unique research and development projects, which will allow them to gain market power, become self-sufficient and start to provide returns within a short period of time.

The life of a fund is usually five to seven years and produces returns of 40% internal rate of return (IRR) or above. For example, one of the largest foreign venture funds declared IRR on several projects as high as 70% per annum which resulted in considerable profits for investors. A fund will usually exit a project after four to five years.

However, it is currently impossible to provide detailed figures regarding timing, financing on each stage and returns of domestic venture projects, since venture financing is still undeveloped and the general economic situation is unstable in the long run.

INVESTMENTS

11. What form of investment do venture capital funds take? (For example, equity, debt or a combination.)

Since it is usually impossible to secure obligations from the target company, venture capital funds provide equity financing, especially in the first stages.

Equity financing also has the advantage of allowing funds to nominate their own managers for the governing bodies of target companies. Funds can therefore gain control over the company and get reliable information about the company's activities.

Although equity financing is a priority, sometimes the target company applies for debt financing from the venture fund. This is usually to cover operating costs or to receive bridge financing during the fund's decision making period. Debt financing in this form is always done in combination with basic equity financing.

12. How do venture capital funds value an investee company?

As recently as six to ten months ago, investors would consider investing in a simple licence or patent with little development or commercialisation. However, this is no longer the case and funds are now largely investing in companies already generating income or making a profit.

This demonstrates a considerable change in how capital funds are assessing risk. Previously funds would look at the potential of a business, now they would rather evaluate its sustainability. Instead of evaluating intellectual property (IP) or even the basic idea of the founders, the investors are looking for a developed and well-supported business plan, a proven and tested business concept, and an able management team.

13. What investigations will venture capital funds carry out on potential investee companies?

When considering potential investments, venture capital funds closely examine the target company's business plan and compare it with current market trends to estimate the company's prospects. If the conclusion is positive, the fund carries out a due diligence exercise, which includes the following:

- **Technical due diligence.** Regardless of what stage the project is at, technical due diligence is the most important part of this process.
- **Legal due diligence.** This covers IP matters and, where the target company has existed for some time, its documentation and legal history are also subject to thorough legal due diligence.
- **Financial due diligence.** This is carried out for existing target companies.
- **Management due diligence.** The fund assesses the current management of the company, as its abilities will be crucial establishing long-term success.

14. What are the principal legal documents used in a venture capital transaction?

A shareholders agreement regulated under foreign law is usually used as the principle legal document, transferring participatory interests or shares in the target company to the fund (represented by its vehicles) in exchange for future financing.

This is because share or asset purchase agreements under Russian law are generally of limited use, since it is practically impossible to include in the agreement any conditions other than those related to the sale and purchase. For example, representations and warranties (as they are known in common law jurisdictions) are not accepted in Russia and the courts would most likely consider this part of an agreement as void.

Therefore, many investors seek mechanisms to have the transaction governed by foreign law; for example, using a holding company registered outside Russia. While it is theoretically pos-

sible to include some provisions regarding further financing in the purchase agreement, if used the parties to a private equity transaction still usually have additional and detailed shareholders agreements, often also regulated by foreign law.

Stock purchase agreements made under Russian law (used if the investor acquires existing shares) contain provisions on:

- The subject matter of the agreement.
- The level of consideration.
- Mutual rights and obligations of the parties (including completion mechanics).
- Arbitration, in case the parties to the agreement wish to submit their disputes to arbitration.

Normally, venture investment transactions also include changes to the target's constituent documents.

15. What form of contractual protection does an investor receive on its investment in a company?

A significant problem with investing in Russia is the current practical unavailability of shareholders' and similar agreements regulated by Russian law (*see Question 14*).

Recently parties to these transactions have tried to prepare and execute agreements based on the concept of freedom of agreement provided by Russian civil legislation. However, case law has shown that the court system is not yet ready to accept and protect these agreements.

The importance of legal regulation for shareholders' agreements has been evident for a long time and noticed by many local lawyers, but the law which will govern all the basic aspects of shareholder' agreements has not yet been enacted and still exists only as a bill.

Therefore, the parties to a venture investment transaction, even if both are Russian, usually perform the deal through a foreign special purpose vehicle (usually offshore) and submit the agreement to foreign law (usually one of the common law systems) as the only way to execute a comprehensive and effective shareholders' agreement and set out future obligations relating to further financing and the operation of the target company, as well as mutual representations and warranties.

Recent changes to the law regulating LLCs, effective from 1 July 2009, provide that LLC participants can enter into participants' agreements, which may, among other things, regulate voting issues, pre-emption and first refusal rights, and other matters of co-operation among the participants. However, there is no similar regulation for the JSCs.

16. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

The form of equity interest to be taken by a fund depends on whether the target company is a LLC or a JSC (*see Question 1, Types of company*):

- **LLC.** Equity interest in a LLC is represented by a participatory interest, which is not recognised as a security. The participatory interest provides rights to:

- participate in the company's management;
- receive a part of company's profits.

In specific cases the participants of the company can agree to grant a participatory interest holder additional rights similar to those given to a shareholder by preferred shares (for example, rights connected with the management of the company and distribution of profits).

- **JSC.** JSCs issue ordinary and, if necessary, preferred shares, which can be distributed among a limited number of shareholders (closed JSC) or placed and traded publicly (open JSC).

17. What rights does a fund have in its capacity as a holder of preferred shares (for example, what rights to capital and/or to interest)?

Shareholders holding preferred shares cannot vote at shareholders' meetings except in limited cases (generally, matters of restructuring and matters directly related to preferred stockholders' powers) (*Law on Joint Stock Companies (No. 415-II, 13 May 2003)*).

The target company's charter must provide a fixed amount or rate of interest to be paid to the holders of preferred shares and define which part of the company's assets will be delivered to them in case of the company's winding-up. The charter may also allow for the conversion of preferred shares into ordinary shares, in which case the order of any conversion must be set out.

If the company fails to pay interest to its preferred shareholders, they obtain voting rights starting with the first shareholders meeting after non-payment of interests.

18. What rights are commonly used to give a fund a level of management control over the activities of an investee company (for example, board representation, certain acts of the company subject to investor consent)?

The management structure of Russian companies differs from the Anglo-American model. The role of the board of directors in Russian private and public companies is less important, while the shareholders usually control the company's activities. Therefore, it is more important for the fund to have a major shareholding in the company, in the form of a controlling or at least a blocking stock, and to approve the company's general director (chief executive officer). In addition, young companies are usually established as LLCs and closed JSCs, which may have no board at all, provided that the management is performed by a shareholders' meeting and a general director.

19. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation?

Unless the parties to the venture capital transaction submit contractual investment documentation to a foreign law, it is impos-

sible to set any substantial restrictions on the transfer of shares in addition to that provided by the law (*see Questions 14 and 15*). However, the following actions are available:

- Restrictions can be imposed in the constituent documents of Russian-based LLCs on the ability of participants to transfer their participatory interests.
- Even if no additional restrictions are set out in the constituent documents, shareholders of closed JSCs and participants of LLCs have pre-emption rights for any shares or participatory interests offered to a third party, which is not a shareholder or participant of the company.

However, due to certain legislation lags in the regulation of pre-emption rights, it is highly recommended to incorporate all restrictions in a comprehensive shareholders' agreement regulated by a foreign law, preferably a common law system.

20. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company (for example, drag-along and tag-along rights)?

Russian corporate legislation does not recognise drag-along and tag-along rights. While these concepts might be recognised by the courts in the future under the freedom of contract concept, currently the only guaranteed way for the investor to get this type of protection is to be a shareholder of a foreign holding company solely owning the target company in Russia (*see Questions 14 and 15*).

21. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

Statutory pre-emption rights are provided for LLCs and JSCs (*see Question 19*). However, considering the limited flexibility of these provisions and the impossibility of sufficiently governing the parties' relationship in an agreement, it is advisable to incorporate pre-emption rights in the shareholders agreement of a foreign holding company (*see Questions 14 and 15*).

22. What consents are required to approve the investment documentation?

No consents of official bodies are required. However, there are regulations regarding documentation to be executed and submitted to certain regulatory bodies by Russian-based mutual investment funds and incorporated investment funds.

23. Who covers the costs of the venture capital funds?

Generally the fund bears its own costs. However, there are no restrictions on the costs of foreign venture capital funds being paid by any other entity or person. It is not uncommon for costs to be met out of the fund's investment where the investment is completed. If not, it is usually the management company who covers the costs.

FOUNDER AND EMPLOYEE INCENTIVISATION

24. In what ways are founders and employees incentivised (for example, through the grant of shares, options or otherwise)? What are the resulting tax considerations?

It is not customary to grant shares and options to employees except for the top managers. Employees are usually incentivised through bonuses which may be connected with efficiency or length of service.

Founders commonly have shareholdings and occupy top management positions in venture companies. They are therefore directly motivated to be successful and increase capitalisation of the company.

Employees' bonuses are subject to general payroll tax at a flat rate of 13%.

25. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture (for example, good leaver/bad leaver provisions and restrictive covenants)?

As most venture investors acting in Russia are foreign or international venture funds, they generally implement the same conditions of financing and protections as they use in other countries. This also means that all the usual contractual instruments used to ensure founders' commitment can be used for Russian-based foreign venture companies and their respective founders. Founders' lock-ups are quite common and can be structured under Russian law. Good leaver and bad leaver provisions are usually structured outside Russia, since shareholders' agreements regulating these issues are most commonly governed by foreign law.

EXITS

26. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

A venture capital fund's stock in an unsuccessful company is primarily realised through a sale or buyout.

However if the target unsuccessful company is a LLC the investor may have an additional option under the Law on Limited Liability Companies (*No. 14-FZ, 8 February 1998*). If included into the charter of the target company, this option provides that in exchange for the investor's equity stock the company can, within a set period of time, deliver to the investor a part of its total assets in an amount pro rata to the investor's shareholding in kind or the cash equivalent. The participant of a LLC can use this right at any time. If there are no investors willing to purchase the equity stock and a management buyout is not possible, this type of exit may become a valuable tool for the investor. The exit repayments are

exempted from taxation as part of the initial contribution made by the investor to the company, so the investor does not have to pay a profit tax in Russia for the amount of gains up to its effected contributions (see *Question 2, Income tax*); although, the investor would still be subject to taxation if it sold its equity stock normally. If the investor owns substantial equity stock, such an exit may have a serious impact on the company.

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

A venture capital fund holding equity stock in a successful company usually has a wide range of ways to realise its investment, including:

- Initial public offering (IPO).
- Management buyout.
- Leveraged buyout.
- Sales to strategic investors.

The most commonly used exit is a sale to a strategic investor, due to the limited opportunities for international IPOs, the underdeveloped stock market and the lack of private equity transaction regulations. Nevertheless, IPOs in Russia do take place and it is expected that their numbers will grow in future with the further development of infrastructure and the securities market.

28. How can this exit strategy be built into the investment?

An exit strategy is normally built into the investment by contractual means. In particular, by its inclusion in the shareholders' agreement or any similar instrument used to govern the parties relationship.

The investors must consider any provisions in the target company's foundation documents which could delay or make impossible a desired strategy exit (for example, a restriction on selling a participatory interest in a LLC, if the investor wishes to sell those participatory interests to the strategic investor).

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