FDI Restrictions in Russia: Toward New Legislation*

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Russia's improving economic position and ongoing production growth, coupled with high global prices on its chief exports of hydrocarbons, is attracting significant foreign direct investment (FDI) into the country. This increased investment activity is revealing sufficient inconsistencies in Russian legislation regulating FDI.

Russia, like every sovereign state, has the right to maintain control over sectors of its economy and particular enterprises important to its security. Economic experience, however, show that FDI restrictions decrease competitiveness, create substantial barriers to introducing cutting-edge technologies in production and management, and reduce economic growth.

How do countries maintain control over strategically important sectors and enterprises while attracting FDI?

President Vladimir Putin called for creating an effective regulatory system for foreign investment in his annual address to Parliament in the spring of 2005. Consequently, this question tops the Russian government's agenda. While no all-encompassing legislation exists at the moment, numerous direct and indirect restrictions on foreign investment can be found in a fairly wide range of sectors. Among sectors where restrictions are already in place are aerospace, insurance, mass media, natural monopolies and real estate.

These restrictions can limit the share of foreign ownership in companies, directly prohibit foreign ownership (in the case of real estate) or restrict participation in government-led tenders or privatization auctions. Indirect restrictions are linked to administrative barriers, especially in banking, telecommunications and natural resource extraction sectors, where the main concern is access to government-protected information.

Current restrictions are frequently formulated in such a way that foreign investors do not even realize they may face a problem in acquiring an asset. The best example here is this year's case of Siemens, which was barred from buying a share in Silovye Mashiny (Power Machines) during final stages of the deal and for not completely transparent reasons. It is difficult to say whether barring the deal was justified, but the rejection pushed both sides – government and foreign investors – to act. The necessity for clear rules of the game for FDI in strategic sectors became clear.

The Russian Federation government is now drafting a law on FDI limitations, which will unite acts and regulations found in various other legislation and make limits on FDI clear and understandable for investors. The law will also provide a complete list of sectors in which restrictions can be enacted; all other sectors will be declared completely free of restrictions for foreign investment.

In developing this legislation, the Russian government has encountered a series of problems, or, more exactly, a series of trade-offs, the most important of which are:

- "Everything is prohibited except that allowed by the government" versus "Everything is allowed except that prohibited by the government";
- Level of restrictions: by branch, sector, company or other criteria;
- Flexibility of the government and the president in allowing foreign access versus an inflexible list of reasons to reject a proposal;
- Using state security as the sole basis for barring foreign investment versus state and economic security;
- Regulating FDI only in existing assets versus regulating FDI in both brownfield and greenfield projects.

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Roundtable on U.S. Experience

American experience on limiting FDI in strategic sectors was the theme of a round-table co-sponsored by the Center for Strategic Research and the American Chamber of Commerce in Russia on Oct. 7. The roundtable, held at the Center for Strategic Research in Moscow, gathered Russian experts in this field and top-level representatives from the President's Administration, ministries and parliament, as well as experts from the U.S.

Roundtable participants discussed U.S. legislation on restricting FDI and its associated problems. They also heard experts' opinions on the effectiveness – or lack there-of – of the U.S. system.

Salient Points

As a result of the discussion, several best-practices were identified, which could be useful in drafting new Russian legislation, including:

1. Using a multi-departmental committee to review investors' requests, headed by an economic ministry representative, but including military and security representatives, who must reach a consensus. If the committee cannot reach consensus, the president has the right to make a final decision.
2. Listing sectors where foreign investment is limited and deals must be reviewed. (While submitting deals for review is voluntary, the committee has the right to review any transaction in strategic sectors not receiving preliminary approval and can cancel the deal, even after five years. However, once approved, the deal cannot be reviewed in the future).
3. Being flexible in determining threats to national security, but not so much as to cloud the decision-making process.
4. Precisely limiting the time frame for reviewing applications.
5. Establishing a clear procedure for risk analysis for each request, including risk to national security if the government relinquishes control over an asset and risk associated with the investor and his/her national origin.
6. Setting conditions on allowing foreign investor participation in strategic sectors, such as participation of nationals in top management, limitations on access to information vital to national security, etc.

The near future will show if these principles can be incorporated into the new legislation, the draft of which must be sent to Parliament by the end of the year. ☐