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Strategic sector legislation in Russia: critique and proposal for change

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Abstract

Russia's new Strategic Sector Law, provoked after Siemens of Germany attempted to purchase Power Machines which produces about 90% of turbines in Russia, should have been hailed as Russia's triumph over complicated bureaucracy and foreign investor uncertainty, but most foreign investors decry the law as merely adding an extra lawyer of bureaucracy, needlessly over-broad, and an infringement on foreign direct investor privacy and business confidentiality. To complicate matters further, the Strategic Sector Law has even entangled one prominent Russian investor attempting to enter Russia's subsoil industry. The concerns are grave, but the solutions are easy if Russia is willing to implement them. This Article discusses foreign direct investor concerns and proposes changes to Russia's new foreign direct investment scheme such as simplified notice requirements, a more limited scope of government intrusion into private business affairs, and a narrower list of strategically important activities. While Russia has become a global competitor in the market for foreign direct investment, the country is far from realizing maximum foreign direct investment due in part to easily solvable problems with its Strategic Sector Law.

Keywords

Foreign direct investment, Russia, strategic sector, investor.

"We are being asked what has changed in Russia, why now all these deals are being signed. The regulations have changed considerably; normal conditions have been created."

– BP Chairman Carl-Henric Svanberg in 2011¹

Introduction

From 1991 until mid-2008 no Russian law directly dealt with foreign direct investment in Russia. While some rules governed how foreign investors could interact generally with Russian business entities and other laws incentivized foreign investment in certain geographic areas, Russia had not yet considered a law detailing the types of entities and size of investments that foreign direct investors could invest in. The omission became serious in 2007 when a German entity attempted to purchase a controlling stake in a Russian entity heavily involved in Russia's infrastructure. No legal reason existed to prohibit the German entity from engaging in the proposed transaction

and no governmental agency explicitly had the power to block the transaction, but the takeover was thwarted by an ad hoc jumble of agency action and political disapproval. The fiasco led to Federal Law No. 57-FZ of 2008 which codified the limitations of foreign direct investors to participate in Russia's economy. However, the Strategic Sector Law that many thought would be a model of clarity and a representation of a softening Russian bureaucracy has only garnered investor confusion, fear, and anger. While Russia need not go back to the drawing board, it is time for a second set of amendments to the Strategic Sector Law that directly addresses investor's legitimate concerns while balancing appropriate levels of government oversight.

In 2010 Pepsi executed a \$3.8 billion takeover of Wimm-Bill-Dann, the juice and dairy king headquartered in Moscow. In 2011 a veteran foreign direct investor in Russia, British Petroleum (hereinafter: BP), proposed a £5 billion share swapping deal with State-owned oil company Rosneft. In 2012 BP completed a different deal with Rosneft in a series of transactions worth about \$55 billion combined, but it was not the deal BP had been hoping for. BP currently owns close to twenty percent of Rosneft – a company heavily involved in

¹ Gosling, T., "Russia Bounces Back, Mega FDI Deals Pump Up Confidence", *Russia and India Report*, available at: www.indrus.in/articles/2011/02/09/russia_bounces_back_mega_fdi_deals_pump_up_confidence_12143.html

subsoil exploration.² The latest inflows of foreign direct investment in Russia, including the deals by Pepsi and BP, stand in stark contrast to foreign direct investment in Russia in the early 1990s and 2000s. From 1991 to 2001, foreign direct investment in Russia – a country of about 145 million people³ – totaled a mere \$22 billion.⁴ As a reference, annual foreign direct investment inflows over those ten years tended to be less than a single Pepsi-Wimm-Bill-Dann.⁵ In 2000 foreign direct investment in Russia was \$2.7 per person compared to \$316 per person in the U.S. and \$39 per person in China for the same year.⁶ The current legal foundations of foreign direct investment in Russia are much sturdier than they were in the 1990s or early 2000s. However, if Russia wants to realize its great potential for foreign direct invest-

ment, it needs to consider constructive and meaningful amendments to its 2008 Strategic Sector Law – especially today as investors fret over Russia's political and administrative environment.

Economic Evolution

Foreign direct investment is usually defined as an:

"... investment of foreign assets into domestic structures, equipment, and organizations. It does not include foreign investment into the stock markets. Foreign direct investment is thought to be more useful to a country than investments in the equity of its companies because equity investments are potentially "hot money" which can leave at the first sign of trouble, whereas FDI is durable and generally useful whether things go well or badly."⁷

Foreign direct investment became legally possible in Russia from about 1987.⁸ In 1991, Russia enacted a

2 Kramer, A.E., Reed, S., "BP Will Switch Russian Partners Through a Deal with Rosneft", *New York Times*, available at: www.dealbook.nytimes.com/2012/10/22/bp-near-deal-to-sell-assets-to-rosneft/

3 Povey, G., Melkonian, A. (2012), *Doing Business in Russia: Your Tax and Legal Lighthouse. KPMG in Russia and the CIS Tax and Legal*, p. 6. (the current population of Russia is about 143 million).

4 Jeffries, I. (2010), *Economic Developments in Contemporary Russia*, Routledge, London, p. 310.

5 Ibid.

6 Ibid. P. 309.

7 "Definition of FDI (Foreign Direct Investment)", available at: www.economics.about.com/cs/economicsglossary/g/fdi.htm

8 Frenkel, W.G., Sukham, M.Y. (1993), "New Foreign Investment Regimes of Russia and other Republics of the Former U.S.S.R.: A Legislative Analysis and Historical Perspective", *Boston College International and Comparative Law Review*, No. 16, pp. 338-340.

law specifically dealing with foreign direct investment. The 1991 Federal Law on Investment Activity defined foreign direct investment and created "free economic zones" – generally a "suspension" of the usually applicable laws in favor of rules believed to be more beneficial to commercial activity. The 1991 law was strongly influenced by lingering communist principles.⁹ In 1999 a new law, aimed at mitigating some of those lingering communist principles, created "Special Economic Zones" (preferential treatment for commercial activity), provided for similar treatment of foreign investors and Russian investors, and expanded the concept of private ownership.¹⁰ The 1999 Law was amended by Federal Law No. 116-FZ of 2005, which modified and solidified the existence of Special Economic Zones in Russia. The Russian government regulates entities in Special Economic Zones through a process of "accreditation."¹¹ Today, foreign direct investors must understand the

law governing Special Economic Zones, the law governing strategic sectors, and many other domestic laws and international treaties before investing in Russia. This article will address issues with the 2008 law governing foreign direct investments into strategic sectors and its subsequent amendment only.

Beginnings of Federal Law No. 57-FZ (2008)

The 1991 law created a definition of "foreign investment" that the 1999 law and its subsequent amendment incorporate.¹² However, in 2004 it became clear, to President Putin at least, that rules attempting to define foreign direct investment and confine it to special economic zones would not provide a basis to protect the business entities themselves, which were the subjects of foreign direct investments. President Putin was especially concerned with business entities that were important to the infrastructure and security of Russia. In 2004, to save some of these "strategically important" business entities from becoming completely privatized by foreign direct invest-

9 Butler, W.E. (2009), *Russian Law. 3rd ed.*, Oxford University Press, Oxford, p. 708. (the 1991 law was enacted at "the height of communist influence in the Russian parliament").

10 Ibid. Pp. 709-710.

11 Povey, G., Melkonian, A. (2012), *Doing Business in Russia: Your Tax and Legal Lighthouse. KPMG in Russia and the CIS Tax and Legal*, p. 12.

12 Butler, W.E. (2009), *Russian Law. 3rd ed.*, Oxford University Press, Oxford, p. 709 (Foreign investment includes "All types of property and intellectual valuables contributed to objects of entrepreneurial and other types of activity, as a result of which profit (or revenue) is formed or a social effect is achieved...").

tors and to save other business entities from bankruptcy, President Putin issued a decree.¹³ The 2004 Presidential Edict officially deemed some entities as "strategically important" to Russia's national defense and security.¹⁴ The specific list of entities included companies handling radioactive materials, working with the natural resources of the Russian Federation, or involved in aerospace activities.¹⁵ At the time the list was published, the Russian Government owned 25% to 100% of each of the 518 unitary enterprises and the 546 joint-stock companies on the list.¹⁶ The edict required foreign direct investors to obtain explicit approval from the president before privatizing or acquiring shares from the strategic entities listed in the Edict.¹⁷

13 Gati, T.T., "Russia New Law on Foreign Investment in Strategic Sectors and the Role of State Corporations in the Russian Economy", available at: www.akingump.com/files/upload/Foreign_Investment%20in%20Russian%20Strategic%20Sectors%20-%20by%20Toby%20T.%20Gati.pdf

14 "Edict of the President No. 1009", available at: <http://archive.kremlin.ru/text/docs/2004/08/75174.shtml>

15 Ibid.

16 "Russian Government Explains President's Decree on Strategic Enterprises", available at: www.accessmylibrary.com/article-1G1-158898810/putin-amends-list-strategic.html

17 Ibid; Sprenger, C., "Presentation at the OECD Roundtable on Corporate Govern-

After three years of operating under the Presidential Edict, a 2007 transaction initiated by Siemens of Germany exposed the ambiguities and limitations of the edict. The transaction also exposed the power that Russia's political process held over its economy and sparked investor concerns about domestic investor protectionism.¹⁸ The transaction involved Siemens offer to buy a majority stake in Power Machines, a company that produced about 90% of the turbines in Russia. The Federal Antimonopoly Service (hereinafter: FAS) had no legal reason to block the transaction proposed by Siemens under the 1991 law, the 1999 law, or the 2004 Presidential Edict because Power Machines was not a listed entity. Still, many political officials did not favor the idea of a foreign investor controlling 90% of Russia's turbine production.¹⁹ In response to Siemens' bid, a Russian billionaire and Kremlin insider applied to purchase the exact same stock. Ultimately, the deal was vacated altogether,²⁰ but

nance of SOEs", available at: www.oecd.org/corporate/corporateaffairs/corporategovernanceprinciples/42576825.pdf

18 Heath, J. (2008), "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", available at www.works.bepress.com/jesse_heath/1/

19 Ibid.

20 Ibid.

the ad hoc denial of a foreign direct investor's proposed transaction with a Russian entity prompted President Putin to call for legislation clarifying the rules for foreign direct investors and supervising State authorities alike.²¹

*Federal Law No. 57-FZ (2008)*²²

In mid-2007 "[m]any ministries and governmental institutions" began work on the legislation that President Putin had called for.²³ A year later, Federal Law No. 57-FZ of 2008, "On Procedures for Foreign Investments in the Business Entities of Strategic Importance for Russian National Defence and State Security," was passed amidst a global economic crisis. Unlike the 1991 and 1999

Laws which define and regulate "foreign investment," the 2008 Law defines "control" and regulates "transactions."²⁴ In fact, Federal Law No. 57-FZ of 2008 creates a foreign direct investment regime similar to foreign direct investment regimes in the United States, India and other developed countries.²⁵ The basic policy behind the foreign direct investment regimes in Russia, the U.S., and India is that foreign direct investors are generally free to invest as they please until they trigger the provisions of a law. Under Federal Law No. 57-FZ of 2008, foreign direct investors must understand three general rules before they can determine if a transaction with a Russian entity will or will not require governmental approval.

21 Gati, T.T., "Russia New Law on Foreign Investment in Strategic Sectors and the Role of State Corporations in the Russian Economy", available at: www.akingump.com/files/upload/Foreign_Investment%20in%20Russian%20Strategic%20Sectors%20-%20by%20Toby%20T.%20Gati.pdf

22 "Federal Law No. 57-FZ "On the Procedure for Foreign Investments in the Business Entities of Strategic Importance for Russian National Defence and State Security", available at: www.wipo.int/wipolex/en/text.jsp?file_id=188842

23 Gati, T.T., "Russia New Law on Foreign Investment in Strategic Sectors and the Role of State Corporations in the Russian Economy", available at: www.akingump.com/files/upload/Foreign_Investment%20in%20Russian%20Strategic%20Sectors%20-%20by%20Toby%20T.%20Gati.pdf

24 Butler, W.E. (2009), *Russian Law. 3rd ed.*, Oxford University Press, Oxford, p. 709; See generally Article 2, Federal Law No. 57-FZ of 2008.

25 Fagan, D.N. (2008), "The U.S. Regulator and Institutional Framework for FDI", available at: www.vcc.columbia.edu/pubs/documents/FaganFinalEnglish_001.pdf; Pomeranz, W.E. (2010), "Russian Protectionism and the Strategic Sectors Law", *American University International Law Review*, No. 25, pp. 214-217; Jackson, J.K. (2006), "The Exon-Florio National Security Test for Foreign Investment", *CRS Report for Congress*, available at: www.fas.org/sgp/crs/natsec/RS22197.pdf; "Foreign Investments in India", *Reserve Bank of India*, available at: www.rbi.org.in/scripts/faqview.aspx?id=26

Firstly, the 2008 Strategic Sector Law includes a sweeping definition of "foreign investor" under Articles 2 and 3. Generally, the Strategic Sector Law classifies entities formed under foreign law or controlled by foreign entities as foreign investors regardless of the citizenship of their shareholders, owners or controllers.²⁶ The Law does not apply to foreign investments governed by international treaties to which Russia is a party.²⁷ The Law also does not apply to individuals investing directly in entities of strategic importance involved in subsoil activities if the Russian Federation directly or indirectly controls more than 50% of the total voting stock of that

entity.²⁸ Most importantly, the Strategic Sector Law provides different treatment for investments by foreign states or international organizations (like BP and Pepsi)²⁹ and investments by individual foreign investors.³⁰

Secondly, Article 6 of the Law defines "Strategically important" entities by reference to certain activities deemed to implicate "Russian national defense or State security."³¹ Some of the activities deemed to be "strategically important" under Article 6 include: (1) modification of hydro-meteorological processes and phenomena, (2) modification of geophysical processes and phenomena, (3) using infectious agents (like dairy farming or food production activities), (4) setting-up, constructing, operating and/or decommissioning nuclear facilities, (5) handling nuclear materials and radioactive substances... (6), handling ra-

26 Heath, J. (2008), "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", available at www.works.bepress.com/jesse_heath/1 (The definition of foreign investor is regulated by the existing law on foreign investment. The Law on Foreign Investment's definition of foreign investor includes foreign entities investing in Russia, foreign citizens, and people without citizenship.).

27 Federal Law No. 57-FZ of 2008, Article 2, Section 6; "Report of the Working Party on the Accession of the Russian Federation to the World Trade Organization", available at: www.economy.gov.ru/minec/press/news/doc20111111_5?presentationtemplate=docHTMLTemplate2&presentationtemplateid=76b66780446888f597aef7af753c8a7e&WCM_Page.ResetAll=TRUE&CACHE=NONE&CONTENTCACHE=NONE&CONNECTORCACHE=NONE

28 Federal Law No. 57-FZ of 2008, Article 2, Section 7; Gati, T.T., "Russia New Law on Foreign Investment in Strategic Sectors and the Role of State Corporations in the Russian Economy", available at: www.akingump.com/files/upload/Foreign_Investment%20in%20Russian%20Strategic%20Sectors%20-%20by%20Toby%20T.%20Gati.pdf

29 Federal Law No. 57-FZ of 2008, Article 2, Section 3.

30 Federal Law No. 57-FZ of 2008, Article 3, Section 1.

31 Federal Law No. 57-FZ of 2008, Article 1.

radioactive waste during storage, processing, transportation, and etc.... Regardless of where the transaction to conduct an Article 6 activity occurs, if the activity itself will take place in Russia, the obligations and limitations of the Strategic Sector Law may apply. This means that two non-Russian business entities who draft and confirm a transaction outside of Russia involving an Article 6 activity inside of Russia may be required to seek approval under the Law.³² These foreign entities would be forced to avail themselves of Russia's review procedures unless they ignore the law altogether and risk a subsequent declaration that the transaction is void or forget about the deal and invest elsewhere.³³

The third prong of the Strategic Sector Law revolves around "control."³⁴ As mentioned earlier, the Strategic Sector Law treats foreign states and international organizations differently than it treats individual foreign direct investors. However, all foreign direct investors must notify an "authorized [governmental] body" upon acquiring 5% or

more of the stock of an entity of strategic importance.³⁵ This 5% notice obligation is separate and apart from foreign direct investment limitations under the Law.³⁶ Article 2 of the Law limits foreign states and international organizations from obtaining direct or indirect control of more than 25% of the total voting shares of entities deemed to be strategically important and more than 5% of the total voting shares of strategically important entities involved in sub-soil activities. If a foreign state or international organization wants to exceed these limitations, it must first petition for approval under the Law.³⁷ The rules for individuals seeking to invest directly in Russia are more lax. Under Article 5 of the Strategic Sector Law, individual foreign investors are permitted to control up to 50% of the total voting shares of a strategically important entity or up to 10% of the total voting shares of a strategically important entity involved in subsoil activities. Article 5 of the Law also prohibits individ-

32 Federal Law No. 57-FZ of 2008, Article 2.

33 Pomeranz, W.E. (2010), "Russian Protectionism and the Strategic Sectors Law", *American University International Law Review*, No. 25, pp. 214-217.

34 Federal Law No. 57-FZ of 2008, Article 2, Section 2 and Article 5.

35 Federal Law No. 57-FZ of 2008, Article 14.

36 The 5% notice rule does not itself trigger transaction approval requirements unless the foreign direct investor involved intends to conclude one of the transactions outlined in Article 7, Sections 1 – 4 of the Law – appointing board members, possessing specified percentage of stock, or establishing control.

37 Federal Law No. 57-FZ of 2008, Article 2.

ual foreign direct investors from being able to appoint sole executive bodies, appoint more than half of the board of directors, or appoint more than 10% of the board of directors when strategically important entities are involved in subsoil activities. The Article prohibits foreign direct investors from working through other individuals or entities to directly or indirectly exercise more control over entities of strategic importance than the law allows.³⁸ This is Russia's effort to deter disguised or even secret shareholder agreements, but it is impossible to know how many foreign direct investors are really involved in these types of shareholder agreements.³⁹

The general rule of Federal Law No. 57-FZ is stated in Article 7: If a (1) foreign direct investor wants to engage in a transaction involving a (2) strategic entity or activity that exceeds the amount of (3) control allowed by the Law, the investor must (4) first seek approval by following the procedures set forth in Articles 8 through 14 of the Law.⁴⁰ If a foreign di-

rect investor already directly or indirectly controls more of a strategically important entity than the percentage allowed under the Law, that entity will not be able to engage in future transactions involving its stock. This provision of the Law practically freezes the stock of entities that are not in compliance with the Law.⁴¹

For foreign direct investors to be considered for approval of a transaction implicating the Strategic Sector Law, they must submit an application conforming with the requirements of Article 8⁴² to "the authorized body." In turn, the "authorized body" is governed by procedures set forth in Article 9 of the Law. A 2008 Presidential Edict gave the title of "authorized body" to the FAS.⁴³ The des-

2008, Article 4 (timing for approval and closing transactions).

41 Federal Law No. 57-FZ of 2008, Article 4, Section 4.

42 Examples of Federal Law No. 57-FZ of 2008 Article 8, Section 2 requirements include noting: (1) proposed voting shares involved, (2) registration of the applicant, (3) identity of applicant, (4) activities of the entity involved, (5) structure of the entity involved, (6) etc.

43 Heath, J. (2008), "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", available at www.works.bepress.com/jesse_heath/1/ (6 July 2008 Presidential decree established administrative framework, naming FAS 'authorized body' and creating Committee); Tsyganov, A. (2012), "Control over Foreign Investments in the Economic

38 Federal Law No. 57-FZ of 2008, Article 5, Sections 1-3.

39 Pomeranz, W.E. (2010), "Russian Protectionism and the Strategic Sectors Law", *American University International Law Review*, No. 25, pp. 214-217.

40 See generally Federal Law No. 57-FZ of 2008, Article 7; Federal Law No. 57-FZ of

ignation of "authorized body" emerged after a war between the Federal Security Service and the FAS. While the FAS ultimately won the title of "authorized body" under Article 9, the Federal Security Service did not walk away from the battlefield empty handed.⁴⁴ Pursuant to Article 9, the FAS must register a petition upon receipt,⁴⁵ ensure that the petition complies with Article 8 or send it back to the petitioner to remedy the issues,⁴⁶ and determine if the petitioner has or will establish control over a business entity of strategic importance.⁴⁷ If the transaction will not result in the petitioner obtaining control over a strategically important entity, the FAS sends the petition and its rationale to the petitioner and the Committee – which was also established by the 2008 Presidential Decree.⁴⁸ If the FAS

concludes that the petitioned-for transaction must be approved under the law, the petition is forwarded to the Committee which begins processing the petition.⁴⁹ The law's inspection and analysis of the foreign direct investor also begins as discussed *infra*.⁵⁰ Article 12 of the Law

49 Federal Law No. 57-FZ of 2008, Article 11 (the Committee must adopt one of three decisions: (1) preliminarily approve of the transaction, (2) preliminarily approve of the transaction with conditions, (2) deny approval of the transaction. Preliminary approval or denial of approval for the proposed transaction must be issued within in three working days. This creates a redundancy in the approval mechanism because the transaction must be preliminarily approved or denied within three business days and then officially approved or denied within three months of the FAS receiving the petition.).

50 Federal Law No. 57-FZ of 2008, Article 9, Subsections 3 and 5 and Article 10 (authorized body must request information from state security enforcement concerning whether national defense and state security will be endangered by petitioned-for transaction); Federal Law No. 57-FZ of 2008, Article 3, Section 1; "Foreign investment in strategic industries: first set of amendments. Deboise and Plimpton Client Update", available at: www.deboise.com/files/Publication/d7993aa3-8c3c-43a8-a2d7-ca2d86f3f0fa/Presentation/PublicationAttachment/54dc9828-f07d-450f-b42f-ddec537ba3eb/ForeignInvestmentsinStrategicIndustriesFirstSetofAmendments.pdf (threat to national defense and state security based on combination of factors and conditions endangering vitally important interests of individuals, society and (or) the state; Federal Law No. 57-FZ of 2008, article 10, Section 1 provides the

Entities of Strategic Importance", available at: www.usrbc.org/pics/File/tsy-ganov/FZ-57%20USRBC%202012%20%5BCompatibility%20Mode%5D.pdf

44 Heath, J. (2008), "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", available at www.works.bepress.com/jesse_heath/1/

45 Federal Law No. 57-FZ of 2008, Article 9 Section 1, Subsection 1.

46 Federal Law No. 57-FZ of 2008, Article 9, Section 1, Subsection 2.

47 Federal Law No. 57-FZ of 2008, Article 9, Section 1, Subsection 3.

48 Federal Law No. 57-FZ of 2008, Article 9, Section 2.

permits the Committee to approve the petition subject to certain obligations or conditions. However, if the Committee determines that the proposed transaction cannot be approved in any form, the Committee must notify the petitioner and provide grounds, adopted by the authorized body, for that decision.⁵¹ The entire approval process should not last more than three months,⁵² and petitioners may challenge the decisions and actions (or inaction) of the FAS and the Committee in court or at arbitration.⁵³

Article 15 states that any transaction involving a foreign direct investor and a strategic entity that fails to comply with the law is void under civil legislation. If the transaction cannot be declared void, the FAS may file a lawsuit to deprive the foreign direct investor of

voting rights.⁵⁴ Under Federal Law No. 57-FZ of 2008, a foreign direct investor receiving preliminary approval for a transaction by the Committee under Article 11 who is later denied approval for the transaction by the FAS under Article 9 must alienate the disputed stock within three months after the FAS notifies the foreign direct investor that final approval will not be granted.⁵⁵

*An Amendment: Federal Law No. 322-FZ (2011)*⁵⁶

In 2011 the Strategic Sector Law was changed to ease restrictions governing foreign direct investors and to simplify some of the procedures required for approval of petitioned-for transactions covered by Law. The amendments came in the form of Federal Law No. 322-FZ of 2011 which generally does five things:⁵⁷

(1) Exempts international financial organizations from the law if they

factors considered; "Salans Client Alert, 2011", available at: www.salans.com/en-GB/sitecore/Content/Salans/Global/Items/People/S/~//media/Assets/Salans/Publications/2011/20111202-Strategic%20Investment%20Law%20Amendments%20ENG.ashx (After the 2011 amendment, the FSB and Ministry of defense determine whether the petitioned-for transaction represents a threat to national defense and state security.).

51 Federal Law No. 57-FZ of 2008, Article 9, Section 4.

52 Federal Law No. 57-FZ of 2008, Article 11, Section 4.

53 Federal Law No. 57-FZ of 2008, Article 10, Section 7.

54 Federal Law No. 57-FZ of 2008, Article 15, Section 2.

55 Federal Law No. 57-FZ of 2008, Article 15, Section 5.

56 "Federal Law No. 322-FZ", available at: www.tax.eycis.info/RL.nsf/da516d467fd-cef4dc325695f00338be0/e9455c806c97d705c32575bb003704fe?OpenDocument/

57 Ibid; "Foreign Investment and Strategic Investments in Russia", *Russian Law Online*, available at: www.russianlawonline.com/content/foreign-investments-strategic-investments-russia

have been established under agreements or treaties to which Russia is a party,

(2) Exempts transactions between strategic entities controlled by Russia and Russian citizens unless the Russian citizen has dual citizenship

(3) Increases the permissible amount of control individual foreign investors in strategic entities involved in subsoil activities may obtain from 10% to 25% under Article 5 of Federal Law No. 57-FZ of 2008

(4) Removes the 'operation of radiation sources,' 'data encryption by banks,' and 'distribution and maintenance of cryptographic devices and services' from the list of activities deemed strategically important under Article 6 of Federal Law No. 57-FZ of 2008, and

(5) Simplifies the procedure for approving petitions by providing for one approval by the FAS instead of preliminary approval by the committee and final approval by the FAS under Articles 9 and 11 of Federal Law No. 57-FZ of 2008.

Many investment firms in Russia believe that the FAS is preparing a second set of amendments, but no tentative date has been established yet and the substance of this second set of amendments is not known either.⁵⁸

⁵⁸ "Recent Amendments to the Russian Strategic Investments Law", *Squire Sand-*

The Committee and First Applicants

The Committee reviewing foreign direct investor petitions was originally composed of seventeen members, with Vladimir Putin serving as Chairman of the Committee.⁵⁹ The Committee members approve or deny the petitions of foreign direct investors by majority vote, which is valid if more than half of the Committee members are present.⁶⁰ Currently, the Committee is composed of 19 members who continue to approve or deny petitions by majority vote.⁶¹

At the inaugural meeting on 10 October 2008, the Committee discussed two easily approvable transactions proposed

ers Client Newsletter, available at: www.squiresanders.com/de/recent_amendments_to_the_russian_strategic_investments_law

⁵⁹ Gati, T.T., "Russia New Law on Foreign Investment in Strategic Sectors and the Role of State Corporations in the Russian Economy", available at: www.akingump.com/files/upload/Foreign_Investment%20in%20Russian%20Strategic%20Sectors%20-%20by%20Toby%20T.%20Gati.pdf

⁶⁰ *Ibid.*

⁶¹ The Russia Monitor, Strategic Sectors Law Update – First Commission Meeting of 2012, (2012) (available at <http://therussia-monitor.com/2012/06/03/strategic-sectors-law-update-first-Committee-meeting-of-2012/>) (updated list with Medvedev as chairman, modified and added members).

by foreign direct investors. The first transaction involved Alenia Aeronautica's acquisition of a 25% block of stock in Sukhoi Civil Aircraft for \$183.1 million. The transaction had already received President Putin's approval before the Strategic Sector Law emerged in August of 2008, and the Committee quickly approved the transaction officially.⁶² The second transaction also received President Putin's approval before the Strategic Sector Law came into force in 2008. The transaction involved Archangel Diamond Corporation's acquisition of a 49.9% stake in Arkhangelskoe Geologodobychnoe Predpriyatie which owns exclusive subsoil rights to the Verkhofina Grib Pipe Diamond Mine.⁶³ However, when the Committee approved the Archangel Diamond – Arkhangelskoe Geologodobychnoe Predpriyatie transaction, its approval came with a condition under Article 12 of the Strategic Sector Law. The Archangel Diamond Corporation eventually terminated the Share Purchase Agreement due to unresolvable issues with the Russian Government.⁶⁴ One of those issues was the condition the Committee attached to their approval of Archangel Diamond's peti-

tioned-for transaction. The condition was that the Russian Government would have exclusive authority to control the amount of diamonds the strategic entity (and the foreign direct investor) would be permitted to process from the mine. Archangel Diamond would not agree to this condition.⁶⁵

Article 12 of the Strategic Sector Law permits the Committee to attach certain obligations or conditions to the approval of a foreign direct investors proposed transaction which may include:

- (1) Compliance with state secret regulations
- (2) Continuous production of supplies for state defense orders
- (3) Adherence to certain prices or tariffs under the Federal Law on natural monopolies
- (4) An agreement to follow the Russian Government's instructions in the event martial law is declared
- (5) An agreement to maintain the same number of employees for a time, and/or
- (6) Limitations on processing natural resources extracted from Russian subsoil.⁶⁶

62 Gati at 11.

63 Sergey Budylin, Dmitry Dyakin, Dmitri Evseev, Ekaterina Gill, Jesse Heath and Christopher Kelley, *Russia, International Lawyer* 44.1, p. 737 (Spring 2010).

64 *Id.*

65 Sergey Budylin, Dmitry Dyakin, Dmitri Evseev, Ekaterina Gill, Jesse Heath and Christopher Kelley, *Russia, International Lawyer* 44.1, p. 737 (Spring 2010).

66 Vasilyev, Vasiliy, *Legal Restrictions on Foreign Investment in the Russian Mining*

From 2008 to 2009, when the global economy was falling into recession, the FAS received 108 requests for clarification of the Law, 87 applications from foreign direct investors for preliminary approval of proposed transaction resulting in control, and 323 notifications that investors had permissibly acquired 5% or more in stock of a strategic entity.⁶⁷ Twenty-three applications were returned to investors during that year due to petitioners not gaining control over strategic entities. The Committee actually reviewed 20 of the 87 petitions for preliminary approval under the unchanged Strategic Sector Law.⁶⁸

From the law's enactment in 2008 through the 2011 Amendment to the Strategic Sector Law, the FAS has considered 243 petitions from foreign direct investors for approval of transactions under the Law. Seventy-three of those 243 petitions were returned to petitioners due to "non-establishment of control over strategic economic entities."⁶⁹ The

Committee has reviewed more than 137 of the 243 applications, and only eight petitioned-for transactions have been denied.⁷⁰ Of the eight petitioners denied approval for their proposed actions, none have appealed the decision to any Russian tribunal. Russia's domestic courts may hear foreign direct investor disputes under the Law, and International Arbitration Tribunals have found jurisdiction to resolve disputes between foreign direct investors and the Russian Government as well.⁷¹ From 2008 through the 2011 Amendment, the Committee approved Twenty-six petitioned-for transactions subject to certain obligations or conditions.⁷²

ganov/FZ-57%20USRBC%202012%20%5BCompatibility%20Mode%5D.pdf

70 *Id.*; Transcript of Prime Minister Putin's remarks to the Russian Government's Foreign Investment Oversight Commission, 2 May 2012 (available at <http://government.ru/eng/docs/18852/>).

71 Sergey Budylin, Dmitry Dyakin, Dmitri Evseev, Ekaterina Gill, Jesse Heath and Christopher Kelley, *Russia, International Lawyer* 44.1, p. 737 (Spring 2010).

72 *Id.*; The Russia Monitor, *Strategic Sectors Law Update – First Commission Meeting of 2012*, (2012) (available at <http://therusiamonitor.com/2012/06/03/strategic-sectors-law-update-first-Committee-meeting-of-2012/>); Devyatyarov, Eugene, FAS will oblige Singaporeans to observe state secrets, *Izvestia* (2012) (available at <http://izvestia.ru/news/524361>) (Conditions for the Changi Airport Group transaction in-

Sector, *World Finance Review*, p. 32, 34 (2011) (available at http://www.yklaw.ru/datadocs/doc_2431bu.pdf).

67 *Sergey* at 737.

68 *Sergey* at 737.

69 Tsyganov, A. (2012), "Control over Foreign Investments in the Economic Entities of Strategic Importance", available at: [www.usrbc.org/pics/File/tsy-](http://www.usrbc.org/pics/File/tsyganov/FZ-57%20USRBC%202012%20%5BCompatibility%20Mode%5D.pdf)

The numbers seem encouraging, but one commentator suggests that many of the applications approved by the Committee are petitions by entities formed under foreign law but controlled by Russian citizens.⁷³ The assertion alone raises a number of questions: (1) how many foreign direct investors in Russia are actually foreign, and (2) is Russia engaged in a course of domestic investor protectionism disguised as foreign direct investment? The answers require comprehensive studies beyond the scope of this article.

Analysis

In 2011, foreign direct investment in Russia was \$56 billion – which makes Russia one of the fastest recovering countries in terms of foreign direct investment (FDI) inflow after the 2008 economic crisis.⁷⁴ Despite the growth in

cludes secrecy of certain airport operations and compliance with Government orders if martial law is declared).

73 The Russia Monitor, Strategic Sectors Law Update – First Commission Meeting of 2012, (2012) (available at <http://therussia-monitor.com/2012/06/03/strategic-sectors-law-update-first-Committee-meeting-of-2012/>).

74 Gosling, T., "Russia Bounces Back, Mega FDI Deals Pump Up Confidence", *Russia and India Report*, available at: www.indrus.in/articles/2011/02/09/russia_

FDI after the 2008 economic crisis,⁷⁵ foreign direct investors still have cause for concern. Early analyses of the 2008 Strategic Sector Law by the Oxford Analytica Daily Brief Service suggest the Law may complicate transactions for foreign direct investors who are not establishing 'control' over strategically important entities since all foreign direct investors are now required to provide 5% notice under Article 14 of the Law.⁷⁶ Practically, the Law has added an extra set of procedures for investors who do not trigger the Law at all. The procedures that govern the form of foreign direct investor's 5% notice to the authorized body is not yet entirely clear.⁷⁷ This extra layer of administrative burden on foreign direct investors may deter some foreign direct investors from

[bounces_back_mega_fdi_deals_pump_up_confidence_12143.html](http://www.oxfordanalytica.com/analysis/bounces_back_mega_fdi_deals_pump_up_confidence_12143.html)

75 Povey, G., Melkonian, A. (2012), *Doing Business in Russia: Your Tax and Legal Lighthouse. KPMG in Russia and the CIS Tax and Legal*, p.7. (study shows foreign investment activity is highly concentrated in Moscow, St. Petersburg, Sakhalin, and Arkhangelsk while 37 other regions attracted less than \$100 million in FDI from 2006 to 2010).

76 Federal Law No. 57-FZ of 2008, Article 14; Oxford Analytica Daily Brief Service, *Russia: Strategic sectors law has mixed effects (2008)* (available at <http://search.proquest.com.ezaccess.libraries.psu.edu/docview/192446149>).

77 *Id.*; *Gati* at 14.

directly investing in Russia altogether. For foreign direct investors who do trigger the provisions of the Law, the test for determining what kinds of transactions may constitute a "threat to national defense or security" is not defined in the Law and involves a subjective determination by the Federal Security Service, the Ministry of Defense, and potentially the Committee itself.⁷⁸ This subjective approach fuels foreign director investor fears of protectionism and promotes unpredictability under the Law. A clear list of factors used to define a threat to national defense or security should be provided under the Law to curtail internal political pressures and increase predictability in the business environment. In fact, clarity and ease of filing for foreign direct investors under Federal Law No. 57-FZ of 2008 and its subsequent amendment should be a priority for future amendments. Articles 8-14 of the Strategic Sector Law could easily be clarified and simplified by providing a standardized form to foreign direct investors who then fill-in blanks or check boxes since Article 8 of the Law asks for standard information. A standardized form would also answer the question of how much detail investors must include in their petitions as Article 8 fails to provide any such in-

⁷⁸ Heath at 37.

struction. A system of online filing for approval and 5% notice would increase the portability of petitions for reviewing state authorities, allow timely filing and receipt of FAS decisions, modernize an area of Russia's business culture, and attract foreign direct investors concerned with the administrative burden of investing in Russia.

However, amendments providing clearer and simpler filing requirements will do nothing to increase investor perceptions of Russia's political, internal administrative, and macro-business environment. In 2011, Russia ranked 143 out of 183 countries in the Corruption Index, which measures perceived levels of public sector corruption.⁷⁹ Russia's rating of 2.4 out of 10 on the Corruption Index places it behind Ethiopia, Pakistan, Lebanon, and many others.⁸⁰

⁷⁹ Transparency International, Corruption Perceptions Index 2011 (available at <http://cpi.transparency.org/cpi2011/results/>).

⁸⁰ U.S. Department of State, Bureau of Economic and Business Affairs, 2012 Investment Climate Statement – Russia (available at <http://www.state.gov/e/eb/rls/othr/ics/2012/191223.htm>); Transparency International, Corruption Perceptions Index 2011 (available at <http://cpi.transparency.org/cpi2011/results/>); "Positioned for Growth: Ernst and Young's 2012 Attractiveness Survey", *Ernst and Young*, available at: [www.ey.com/Publication/vwLU-Assets/Positioned_for_growth/\\$FILE/Positioned_for_growth.pdf](http://www.ey.com/Publication/vwLU-Assets/Positioned_for_growth/$FILE/Positioned_for_growth.pdf) (Consider

Russia also ranks 120 out of 183 on the World Bank's Doing Business Index. A comprehensive survey of foreign direct investors⁸¹ conducted by Ernst and Young in 2012 shows that 53% of foreign direct investors are primarily concerned with "improving the effectiveness of law" in Russia.⁸² Forty-seven percent of foreign direct investors said Russia needs to work on reducing bureaucracy, and 37% of foreign direct investors said enhancing the transparency of business regulations would make Russia a more attractive investment environment."⁸³ Sixty-two percent of foreign direct investors surveyed said that Russia's political, legislative, and administrative environments needs improvement.⁸⁴ Foreign direct investors most often complain about the high level of governmental discretion involved in the political and administrative environment in Russia.⁸⁵ Critics suggest that foreign direct investors

Russia's involvement with the OECD anti-bribery convention in 2012).

81 "Positioned for Growth: Ernst and Young's 2012 Attractiveness Survey", *Ernst and Young*, available at: [www.ey.com/Publication/vwLUAssets/Positioned_for_growth/\\$FILE/Positioned_for_growth.pdf](http://www.ey.com/Publication/vwLUAssets/Positioned_for_growth/$FILE/Positioned_for_growth.pdf) (for survey methodology).

82 *Id.* at 35.

83 *Id.* at 37.

84 *Id.* at 4.

85 *Id.* at 37.

need not only be cautious of high-level politics and state intervention, but also poor business practices by local business partners and interference with business relations at the local administrative level.⁸⁶ Those critics suggest that Russia's culture may be ingrained with a lack of respect for property rights and hold little concern for interference with business relations.⁸⁷ Due to low levels of research and development in the country, foreign direct investors believe that Russia's culture of innovation and entrepreneurship needs improvement as well.⁸⁸ These concerns fall outside the scope of Federal Law No. 57-FZ of 2008 and its subsequent amendment, but the issues heavily weigh on investor's initial decision of whether or not to attempt to grapple with the Strategic Sector Law at all.

The Ernst and Young Survey shows 39% of foreign direct investors surveyed believe the mining, oil, and gas industries will attract the most foreign direct investment in Russia over the next three years.⁸⁹ Twenty percent of foreign direct investors believed that informa-

86 Sergey Budylin, Dmitry Dyakin, Dmitri Evseev, Ekaterina Gill, Jesse Heath and Christopher Kelley, *Russia, International Lawyer* 44.1, p. 737 (Spring 2010).

87 *Sergey* at 737.

88 Ernst and Young at 17.

89 *Id.* at 42.

tion and communication technologies will attract the most investments.⁹⁰ Entities engaged in subsoil and telecommunications activities in Russia are strategically important entities under the Law,⁹¹ and tend to be closely related to the infrastructure of Russia as well – which Russia hopes to improve and modernize through increased foreign direct investment.⁹² When the Strategic Sector Law was initially being discussed in 2008, then-Minister of Economics German Gref, strongly opposed including activities of natural monopolies like pipeline industries, rail transportation, seaport and airport activities, and electricity and heating grids in Article 6 of the Law.⁹³ "It is wrong to stoop to restricting investment in infrastructure," Mr. Gref said as the law was being drafted in 2007. "While talking about the priority of the security framework, the government has

forgotten about the need to improve the mechanisms of management."⁹⁴ Federal Law No. 322-FZ of 2011 did not address Mr. Gref's concerns. In fact, the 2011 Amendments to Federal Law No. 57-FZ of 2008 were criticized by investors as failing to address one of foreign direct investor's major concerns – the list of activities in Article 6.⁹⁵ Early analyses of the 2008 Strategic Sector Law revealed that the Article 6 list scared foreign direct investors away from entering into any type of business relationship with Russia at all and consequently deterred much needed modernization.⁹⁶ Despite Federal

⁹⁰ Id.

⁹¹ See generally Federal Law No. 57-FZ of 2008, Article 6.

⁹² Vasilyev, Vasiliy, Legal Restrictions on Foreign Investment in the Russian Mining Sector, *World Finance Review*, p. 32 (2011) (available at http://www.yklaw.ru/datadocs/doc_2431bu.pdf).

⁹³ Heath, J. (2008), "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", available at www.works.bepress.com/jesse_heath/1/ ('natural monopolies' defined by existing law beyond the scope of this paper).

⁹⁴ Gosling, Tim, 39 Steps down for the Cabinet's liberal faction, *Russia Profile*, 20 July 2007 (available at <http://www.russiaprofile.org/business/a1184930779.html>).

⁹⁵ "Foreign investment in strategic industries: first set of amendments. Debevoise and Plimpton Client Update", available at: www.debevoise.com/files/Publication/d7993aa3-8c3c-43-a8-a2d7-ca2d86f3f0fa/Presentation/PublicationAttachment/54dc9828-f07d-450f-b42f-ddec537ba3eb/ForeignInvestmentsinStrategicIndustriesFirstSetofAmendments.pdf; "Salans Client Alert, 2011", available at: www.salans.com/en-GB/sitecore/Content/Salans/Global/Items/People/S/~/_/media/Assets/Salans/Publications/2011/20111202-Strategic%20Investment%20Law%20Amendments%20ENG.ashx

⁹⁶ Oxford Analytica Daily Brief Service, *Russia: Strategic sectors law has mixed effects (2008)* (available at <http://search.proquest.com.ezaccess.libraries.psu.edu/docview/192446149>).

Law No. 322-FZ of 2011, foreign direct investors continue to be limited by the Strategic Sector Law's control restrictions when directly investing in entities engaged in printing, fishing,⁹⁷ infectious agent (like dairies or food production), and telecommunications (deemed to be a natural monopoly) activities. However, with regard to fishing, Russia may have a legitimate national security or defense argument. Sturgeons in the Caspian Sea neared extinction in early 2008 due to overfishing in the caviar trade. A ban on sturgeon fishing in the Caspian Sea is currently in effect until 2013.⁹⁸ Further, Russia's telecommunications industry and its infrastructure may not require much more innovation or modernization. Russia ranks fourth in the world for its volume of operational landlines and cellular phone use and has recently become one of the world's largest consumers of Internet.⁹⁹ Still, foreign direct investors and law firms in Russia hope a second set of amendments will narrow the Ar-

ticle 6 list of activities deemed to be strategically important under the Law.¹⁰⁰

Economic protectionism of domestic investors continues to worry foreign direct investors despite Russia's accession to the World Trade Organization (hereinafter: WTO) in 2012.¹⁰¹ Neither Federal Law No. 57-FZ of 2008 nor Federal Law No. 322-FZ of 2011 addressed the heart of investor fears sparked by Siemens' proposed transaction with Power Machines – that the stock Siemens bid on was nearly awarded to a domestic investor who bid on the same stock much later but gained the advantage as a Russian citizen. Protectionism compounded with investor perceptions of political

100 "Recent Amendments to the Russian Strategic Investments Law", *Squire Sanders Client Newsletter*, available at: www.squiresanders.com/de/recent_amendments_to_the_russian_strategic_investments_law (second set of Amendments predicted to remove "infectious agent" activities from the Article 6 list).

101 Pomeranz, W.E. (2010), "Russian Protectionism and the Strategic Sectors Law", *American University International Law Review*, No. 25, pp. 214-217. (Russia has a history of saying one thing and doing another); Kramer, A.E., "U.S. Companies Worry About Effect of Russia Joining W.T.O.", available at: www.nytimes.com/2012/08/22/business/with-russia-joining-wto-us-companies-worry-about-losing-business.html?pagewanted=all&_r=0 (potentially less advantages to American investors due to the Magnitsky Act and absence of Most Favored Nation Status).

97 Federal Law No. 57-FZ of 2008, Article 6 Sections 3 and 40-42.

98 Blomfield, Adrian, Russia bans sturgeon fishing in the Caspian Sea, *The Telegraph*, Mar. 2008 (available at <http://www.telegraph.co.uk/earth/earthnews/3337528/Russia-bans-sturgeon-fishing-in-Caspian-Sea.html>).

99 *Ernst* at 19.

and administrative corruption in Russia create a formidable obstacle for foreign direct investors. The Ernst and Young survey found that 70% of foreign direct investors who were not already established in Russia had no plans to invest in Russia in 2013.¹⁰² Protectionism under the amended Strategic Sector Law may even affect Russian citizens. In 2009 the Committee delayed a petition by a Russian citizen looking to purchase the Russian oil company RussNeft (not to be confused with the largest State owned oil company Rosneft).¹⁰³ The Russian citizen was proposing to purchase RussNeft through a corporation owned piecemeal by nearly 100 offshore entities.¹⁰⁴ Now Deputy Prime Minister of Russia Igor Sechin, who was puzzled by the fact that a Russian citizen had been caught in the net of Federal Law No. 57-FZ of 2008, said at the time that he preferred Russ-

Neft be purchased by a business entity that was or would be registered in Russia – a Russian entity.¹⁰⁵ The full impact of Russia's accession to the WTO in mid-2012 on Russia's perceived course of domestic protectionism remains to be seen. However, Russia should take affirmative steps by stating in a future amendment to the Strategic Sector Law that no discrimination will occur in approving or denying foreign direct investor petitions based on the entity's or individual's home state or whether or not a Russian entity or individual seeks to execute the same transaction.¹⁰⁶

One of the most troubling provisions of the law is found in Article 10, which provides the Federal Security Service with authority to conduct investigations into foreign direct investors before approving or denying a petitioned-for transaction. The experience of one veteran foreign direct investor in Russia, BP, provides an illustration of how foreign direct investors may struggle with equality in business relationships in Russia despite Federal Law No. 57-FZ of 2008. BP's experience in Russia also illustrates the breadth of Article 10 of the Law. As

102 "Positioned for Growth: Ernst and Young's 2012 Attractiveness Survey", *Ernst and Young*, available at: [www.ey.com/Publication/vwLUAssets/Positioned_for_growth/\\$FILE/Positioned_for_growth.pdf](http://www.ey.com/Publication/vwLUAssets/Positioned_for_growth/$FILE/Positioned_for_growth.pdf) (while 80% of foreign direct investors who already had investments in Russia plan to increase or maintain their investment in Russia for 2013).

103 Pomeranz, W.E. (2010), "Russian Protectionism and the Strategic Sectors Law", *American University International Law Review*, No. 25, pp. 214-217.

104 Ibid.

105 Ibid.

106 Heath, J. (2008), "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", available at www.works.bepress.com/jesse_heath/1/

mentioned supra, BP has been fostering a business relationship with Rosneft, Russia's largest State owned oil company. Originally, BP expected the relationship to result in subsoil exploration opportunities and a degree of influence over the economic future of the State owned oil company. Today, BP owns a twenty percent stake in Rosneft, but the British-based oil company had its sights set much higher:

A prospective partnership between BP and state oil company Rosneft was torpedoed [in February of 2012] by litigation from BP's Russian partners in existing joint venture TNK-BP even though the Rosneft deal had Putin's apparent blessing. For smaller-scale investors, sticky-fingered officials and local rivals or partners can bend a pliant legal system to undermine presumed property rights.¹⁰⁷

Kremlin-Rosneft insiders have effectively confined BP to a limited position in its relationship with Rosneft.¹⁰⁸

107 Mellow, C., "Russia Tries to Court Foreign Investment", *Institutional Investor*, available at: <http://search.proquest.com.ezaccess.libraries.psu.edu/docview/903703371>

108 Heath, J. (2008), "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", available at www.works.bepress.com/jesse_heath/1/; Jeffries, I. (2010), *Economic Developments in Contemporary Russia*, Routledge, London, p. 129.

While BP still has a stake in Rosneft, it is far less than a partner in the company, and BP's 20% stake in the oil company doesn't come with any influence over Rosneft's future. As BP struggles to find ways to drill in Russia despite its relationship with Rosneft, Rosneft has bought BP out of TNK-BP (BP's Russian partners)¹⁰⁹ and started drilling in the Arctic and the Black Sea with its new friend and foreign direct investor, ExxonMobil.¹¹⁰ Rosneft's relationship with BP is a prime example of how the political and administrative environment in Russia and the loose criteria for approval under the Strategic Sector Law provides "sticky-fingered officials" with ample discretion to pick favorites. There is another morale to the story though – regardless of being approved under Federal Law No. 57-FZ of 2008, foreign direct investors may still be limited by issues in Russian business culture.

109 Stott, M., "Insight – Putin's Russia: more fragile than it looks", *Reuters*, available at: www.reuters.com/article/2012/11/01/us-russia-putin-idUSBRE8A01HA20121101; Kramer, A.E., Reed, S., "BP Will Switch Russian Partners Through a Deal with Rosneft", *New York Times*, available at: www.dealbook.nytimes.com/2012/10/22/bp-near-deal-to-sell-assets-to-rosneft/

110 "Russia: Investment regulations", available at: www.alacrastore.com/storecontent/eiufxml/VW_VW_MAIN_20111207T1405000001

Before BP's downhill relationship with Rosneft, the British based oil company attempted to foster a relationship with a different State owned company – – Gazprom.¹¹¹ After BP petitioned the FAS for approval of proposed transactions with Gazprom under then emerging Federal Law No. 57-FZ of 2008, Article 10 of the Law became applicable as the law came into effect. Under Article 10 of the Federal Law and the presidential decree establishing the administrative framework of the Law discussed supra, the Federal Security Service may conduct 'operational searches' of the offices of petitioning foreign direct investors under Article 12 and Article 13 of the Law.¹¹² Article 10 also provides the Federal Security Service with a list of information it must provide to the Committee concerning whether or not a proposed transaction represents a threat to national defense or security. However, Article 10 does not provide a checklist for the scope or duration of these operational searches.¹¹³ In addition to the responsibilities of

111 Kramer, A.E., Reed, S., "BP Will Switch Russian Partners Through a Deal with Rosneft", *New York Times*, available at: www.dealbook.nytimes.com/2012/10/22/bp-near-deal-to-sell-assets-to-rosneft/

112 Federal Law No. 57-FZ of 2008, Article 10.

113 Ibid; Heath, J. (2008), "Strategic Protectionism? National Security and Foreign

the Federal Security Service outlined in Article 10, Article 13 provides the Federal Security Service with authority to request and obtain documents and other information from petitioners when conducting its investigation into whether the petitioned-for transaction constitutes a threat to national defense or security.¹¹⁴ Article 13(5) provides that any state, commercial or protected secrets will not be publicly disclosed, but the Law does not exempt these secrets from being discovered or obtained by the Federal Security Service or the FAS. The 'operational search' authority and the authority to request and obtain information from petitioners granted to the Federal Security Service under the 2008 Law was not modified or eliminated by the 2011 Amendment. Therefore, foreign direct investors seeking to establish control in strategic entities doing business in Russia

Investment in the Russian Federation", available at www.works.bepress.com/jesse_heath/1/

114 Federal Law No. 57-FZ of 2008, Article 13, Subsections 1-4; Heath, J. (2008), "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", available at www.works.bepress.com/jesse_heath/1/ ("Operativnorozysknye meropriyatiya," under Article 13 of the Law is essentially law enforcement spying and is further defined by separate law and search measures may include interrogation, examination of documents, bugging of phones, and etc.).

remain at risk that the FSB will require them to open their companies to extensive and seemingly limitless searches. BP experienced one of these searches firsthand in mid-2008. The Federal Security Service searched BP's Moscow headquarters, TNK-BP, in relation to a pipeline dispute, but the search would have been permitted under then emerging Article 10 of Federal Law No. 57-FZ of 2008.¹¹⁵ "They were scanning through pages of documents, looking for the word 'Gazprom,'" said one source familiar with details of the investigation."¹¹⁶ One BP employee was even arrested under allegations of espionage.¹¹⁷ New amendments to the Strategic Sector Law should provide the FSB with criteria that effectively limits the scope and duration of permitted searches of foreign direct investor's files and offices. Criterion limiting Article 10 searches would not only

protect foreign direct investors and curtail internal political pressure but also provide the FSB with a clearer goal that could be accomplished efficiently.

Moving Forward

Accession to the WTO has not been Russia's only advertisement to foreign direct investors. In 2011, President Putin invited sixteen of the world's leading investors, controlling about \$2 trillion in investable assets, to Moscow for a briefing on a Russian Direct Investment Fund.¹¹⁸ President Putin said Russia would invest in the Fund which would invest with foreign direct investors to build roads, produce medicines and modernize ports and warehouses. Many of these infrastructure-related activities are conducted by strategically important entities that fall under the scope of the Strategic Sector Law. The sixteen investors remained cautious.¹¹⁹ Critics say the investment fund will have little impact without systemic changes to accompany it since foreign direct investors are more concerned with corruption in Russia and Russia's complicated bureaucracy than finding an investment partner.¹²⁰ Some

115 Sweeney, C., Zhdannikov, D., "Agents 'hunted Gazprom documents' in BP Russian raids", *Reuters*, available at: www.reuters.com/article/2008/04/02/us-russia-bp-idUSL0251333720080402; Jeffries, I. (2010), *Economic Developments in Contemporary Russia*, Routledge, London, p. 536.

116 Sweeney, C., Zhdannikov, D., "Agents 'hunted Gazprom documents' in BP Russian raids", *Reuters*, available at: www.reuters.com/article/2008/04/02/us-russia-bp-idUSL0251333720080402

117 Ibid.

118 Mellow, C., "Russia Tries to Court Foreign Investment", *Institutional Investor*, available at: <http://search.proquest.com.ezaccess.libraries.psu.edu/docview/903703371>

119 Ibid.

120 Ibid.

concerns may be mitigated by Russia's newest draft changes to the Civil Code.¹²¹ These changes are designed "to introduce fundamental changes to property rights, obligations, contracts, security instruments and intellectual property".

Ironically, one commentator suggests that poor foreign direct investor perceptions of Russia means that the country is greatly undervalued. Jim O'Neill, of Goldman Sachs, who coined the 'BRIC' designation, recently noted that, "... the perception of Russia has made the country a value play among the other BRICs".¹²² Undervalued or not, clear criteria for what constitutes a "threat to national security," clearer and easier filing procedures, an anti-discrimination provision, a narrower Article 6 list, and a limitation on "operational searches" under the Law will attract the attention of resourceful foreign direct investors scared away by unpredictability and opening their offices to the Federal Security Service. Russia should also consider changes in legislation to narrow the list of Article 12 conditions to exclude some of the obligations like maintaining

certain employees or processing limited quantities of natural resources as these conditions unduly usurp business and economic authority from foreign direct investors.¹²³

Russia's foreign direct investments inflows have grown from \$1.16 billion in 1991 to \$10.2 billion in the *first quarter* of 2012.¹²⁴ Actually, the first quarter of 2012 was down about \$3 billion from the first quarter of 2011, but the number does not reflect the expected boost in Russia's investment attractiveness after Russia acceded to the World Trade Organization (WTO) in August of 2012.¹²⁵ The WTO encourages members to maintain "commitments to lower

123 Heath, J. (2008), "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", available at www.works.bepress.com/jesse_heath/1/

124 "Foreign direct investment, net inflows in U.S. \$", *The World Bank*, available at: <http://data.worldbank.org/indicator/BX.KLT.DINV.CD.WD?page=3>; "FDI in Figures 2012", *OECD*, available at: www.oecd.org/daf/internationalinvestment/investmentstatisticsandanalysis/FDI%20in%20figures.pdf

125 "Positioned for Growth: Ernst and Young's 2012 Attractiveness Survey", *Ernst and Young*, available at: [www.ey.com/Publication/vwLUAssets/Positioned_for_growth/\\$FILE/Positioned_for_growth.pdf](http://www.ey.com/Publication/vwLUAssets/Positioned_for_growth/$FILE/Positioned_for_growth.pdf) (60% of respondents believe Russia's accession to the WTO will have a "medium-to-high" impact concerning the country's foreign direct investment appeal).

121 "Positioned for Growth: Ernst and Young's 2012 Attractiveness Survey", *Ernst and Young*, available at: [www.ey.com/Publication/vwLUAssets/Positioned_for_growth/\\$FILE/Positioned_for_growth.pdf](http://www.ey.com/Publication/vwLUAssets/Positioned_for_growth/$FILE/Positioned_for_growth.pdf)

122 MacFadyen, K. (2011), "Russian Reversal", *Mergers and Acquisitions*, No. 2(46), p. 12.

customs, tariffs and other trade barriers, and to open and keep open services markets."¹²⁶ The World Bank expects the move to add three percentage points to Russia's GDP once Russia is settled in.¹²⁷ Ernst and Young expect foreign direct investment in Russia's services sector to grow up to eleven percent based on past experiences of nations acceding to the WTO.¹²⁸ Russia's new commitment to a system of global norms, like those the WTO encourages, should mitigate Russia's perceived leanings toward protectionism, but Russia's actions will speak louder than its words.

The chief executive officer of Sberbank, Herman Gref, noted that Russia's primary goal is to reform its system of federal and local government, its second goal is to reform its system of education, and its third goal is to create a sys-

tem of business values.¹²⁹ If Russia can accomplish these three goals, the political, administrative, and cultural climate in Russia would be ripe for foreign direct investment. As it is, Federal Law No. 57-FZ of 2008 is a good start for Russia – the Law provides a general framework for foreign direct investors seeking to invest directly in Russia's strategically important entities.¹³⁰ The 2011 changes have added some constructive and meaningful provisions to the Strategic Sector Law. Still, Russia is a long way from attracting the kind of foreign direct investment that a diversified economy, a manageable bureaucracy, a *clearer* and *less invasive* Strategic Sector Law, and a culture with business values could muster. Until then, it is too early for champagne.

Conclusion

If Russia truly wants to capitalize on its potential for growth in foreign direct investment in the country, it should propose a meaningful second set of

126 "Understanding the WTO: the Agreements. Overview: a navigational guide", *The World Trade Organization*, available at: www.wto.org/english/thewto_e/whatis_e/tif_e/agrm1_e.htm

127 Kramer, A.E., "U.S. Companies Worry About Effect of Russia Joining W.T.O.", available at: www.nytimes.com/2012/08/22/business/with-russia-joining-wto-us-companies-worry-about-losing-business.html?pagewanted=all&_r=0

128 "Positioned for Growth: Ernst and Young's 2012 Attractiveness Survey", *Ernst and Young*, available at: [www.ey.com/Publication/vwLUAssets/Positioned_for_growth/\\$FILE/Positioned_for_growth.pdf](http://www.ey.com/Publication/vwLUAssets/Positioned_for_growth/$FILE/Positioned_for_growth.pdf)

129 Ibid.

130 "Congressional Votes Pave Way for Permanent normal Trade Relations with Russia and Moldova", *Office of the United States Trade Representative*, available at: www.ustr.gov/russia (The U.S. remains Russia' largest foreign direct investor with investments comprised mostly of manufacturing, banking, and mining activities).

amendments to its Strategic Sector law that includes the following:

1. a simplified 5% notice requirement where investors need only fill-in blanks on a template form,

2. a uniform system of template forms for information requested by the Strategic Sector Law so that investors can easily complete forms and file them quickly,

3. a narrower scope of Article 6 activities to allow foreign direct investment in activities like dairy farming and infrastructure activities posing only minimal threats to national defense and security, and

4. limits on the government's ability to enter and search business premises and require disclosure of confidential proprietary information and other trade secrets.

The above proposals decrease bureaucracy, limit government involvement and abuse without detriment to governmental oversight, curtail bureaucratic and political abuse, and attract foreign direct investment. If Russia fails to address these concerns, the country will scare away emergent, skeptical and niche foreign direct investors working with large amounts of capital.

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Стратегическое отраслевое законодательство России: критический анализ и предложения по изменению

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Аннотация

Новое стратегическое отраслевое законодательство России, Федеральный закон № 57-ФЗ 2008 года и его последующие поправки, Федеральный закон № 322-ФЗ 2011 года теперь контролируют, кто может делать инвестиции и сколько прямых иностранных инвестиций разрешается делать российским лицам, определённых как «стратегически важные для национальной обороны или безопасности». Стратегическое отраслевое законодательство России имеет сходство с уже существующими моделями прямых иностранных инвестиций во многих других развитых странах, например в Соединенных Штатах, но в России оно внушает страх многим иностранным инвесторам, встревоженным масштабами и последствиями законов, созданной бюрокра-

тии и перечнем стратегических мероприятий, которые, по-видимому, исключают иностранных инвесторов (и некоторых российских инвесторов) из крупной инвестиционной деятельности в некоторых прибыльных и, казалось бы, безобидных российских проектах. В данной статье рассматриваются опасения иностранных инвесторов, предлагаются изменения в новую модель прямых инвестиций в России, например упрощенные требования уведомления, более лимитированное государственное вмешательство в частные дела бизнеса, а также более узкий перечень стратегически важных видов деятельности.

Ключевые слова

Прямые иностранные инвестиции, Россия, стратегический сектор, инвестор.

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