Russia

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1. MARKET OVERVIEW

1.1 Types of investors

Russian private equity funds receive funding from a range of investors, including:

- Russian financial institutions;
- high net worth individuals;
- the investment divisions of Russian corporates;
- family offices;
- foreign private equity investors;
- foreign pension funds; and
- development bodies (eg the European Bank of Reconstruction and Development).

Russian-government investment programmes, including RUSNANO and the Russian Direct Investment Fund (RDIF), also are also sources of investment capital.

Russian pension funds and insurers are not yet a major source of funding (although regulatory reform may change this position).

1.2 Types of investments

Historically, the majority of private equity investment in Russia has been at the expansion stage of investment, providing additional capital to enable the business to develop to a point where an exit can be contemplated, whether by sale to a strategic investor or, less commonly, via an IPO. Private equity investors commonly take a minority interest with the founders retaining operational control, although investors are often granted options to increase their stake (sometimes to a controlling interest) over time. Leveraged buyouts of mature businesses are uncommon. Venture capital funding has become more prevalent recently, particularly in the technology sector, backed by Russian government initiatives such as RUSNANO and the Skolkovo Foundation.

Investments have been made across a wide range of sectors, with notable recent deals involving technology, media and telecommunications, consumer goods and services, and infrastructure. Federal Law No. 57-FZ 'On foreign investments in legal entities of strategic importance to the national defence and state security of the Russian Federation' of 29 April 2008 (the Strategic Investment Law) places limitations on investment by foreign entities in a range of strategic sectors (notably natural resources) and

imposes a consent procedure which makes these sectors less attractive for private equity investment, particularly given that the majority of private equity funds are offshore vehicles.

Investments tend to be non-leveraged, consistent with the minority positions taken by private equity investors, but the injection of private equity capital is often a precursor to debt financing, enhancing the credibility of the portfolio company from the lenders' perspective.

2. FUNDS

2.1 Fund structures

Domestic private equity funds in the Russian Federation can be established in the form of: (i) joint stock investment funds (an incorporated fund); (ii) closed unit investment funds (an unincorporated mutual fund); or (iii) investment partnerships.

Joint stock investment fund

A joint stock investment fund is a legal entity in the form of an open joint stock company, the exclusive activity of which is fixed by its charter as investing in assets in line with standards set out in its investment declaration.

The investment declaration must be approved by the general meeting of shareholders of the joint stock investment fund (but the charter may reserve this power to its supervisory board). The investment declaration also has to be filed with the Central Bank of Russia (CBR). The joint stock investment fund is entitled to pursue its activities only under a licence issued by the CBR.

The property of the joint stock investment fund is divided into property designated for investing (investment resources) and property designated for supporting the operations of the fund.

The investment resources of the joint stock investment fund are transferred to a management company on a trust management basis. Trust management means that the management company manages the investment resources on behalf of the joint stock investment fund, must hold the assets separately to its own and, in its dealings with fund assets, must specify that it acts in the capacity of trust manager. The management company must meet the requirements set out in Federal Law No. 156-FZ 'On investment funds' of 29 November 2001 (the Investment Funds Law) and requires a licence issued by the CBR to act as trust manager of a joint stock investment fund.

A joint stock investment fund is not entitled to issue securities other than ordinary registered shares. Shares of a joint stock investment fund may only be issued by open subscription, except when shares are intended for qualified investors (as defined in Federal Law No. 39-FZ 'On the Securities Market' of 22 April 1996). The charter of a joint stock investment fund may or, where it is established by regulatory acts of the CBR, must provide that the securities of the fund may be owned only by qualified investors.

Unit investment fund

Unlike joint stock investment funds, a unit investment fund is not a legal entity but an unincorporated mutual fund.

A unit investment fund comprises property transferred by investors (usually cash for investment purposes) to a management company to be held in trust management on the condition that this property will be pooled with the property of other investors and property acquired in the course of the life of the fund.

A share in the right of ownership of the fund is certified by a security (unit) issued by the management company. The rights of unit holders include the right to demand proper trust management from the management company, to participate in the general meeting of unit holders and to receive monetary compensation on termination of the fund.

Russian law provides for three types of unit investment funds: open, interval and closed. Private equity funds can be established only in the form of closed unit investment funds, which differ from the other two types of unit investment funds in that the unit holders of a closed unit investment fund are not entitled to demand termination of the trust management agreement prior to expiration of its term (except in cases stipulated by law).

The relationship between the management company and the investors in the fund is established by trust administration rules, which must be registered with the CBR. The management company carries out all transactions with the fund's property in its own name, but must indicate that it is acting in the capacity of a trust manager (and will otherwise be liable in person and with only its own property).

The management company must meet the requirements set out in the Investment Funds Law and is entitled to pursue its activities only under a license issued by the CBR.

Investment partnership

Federal Law No. 335-FZ 'On investment partnership' of 28 November 2011 (the Investment Partnership Law) introduced the investment partnership. This is a contractual arrangement enabling two or more partners to arrange collective investments without establishing a separate legal entity.

Activities of an investment partnership may include both equity investment (acquisition and/or sale of non-publicly traded shares and participatory interests) and non-equity investment (such as acquisition of bonds and derivative financial instruments).

An investment partnership comprises two types of partners: (i) managing partners, which are responsible for the management of the investment partnership; and (ii) ordinary partners. Managing partners are allowed to make both cash and in-kind contributions to the investment partnership, but ordinary partners are required to contribute cash. Managing partners may receive a management fee for their management activities.

An investment partnership is established by an investment partnership agreement, which may include provisions on the following:

- rights and duties of partners and the managing partner;

- remuneration of the managing partner;
- the size and type of partners' contributions;
- capital call procedures;
- conduct of the investment partnership's business (management and decision-making procedures, or establishment of an investment committee);
- distribution of profits;
- apportionment of the partners' shares upon a creditor's demand; and
- exit rules.

There is no requirement to register an investment partnership agreement with the CBR.

The partners' common property must be accounted for in a separate balance sheet to the property of the managing partner(s).

Partners (other than the managing partner) may transfer their interests in the investment partnership to other partners or third parties subject to pre-emptive rights for the other partners.

Partners are liable on a joint and several basis with all their property for non-contractual obligations and contractual obligations assumed in relation to non-commercial parties. Ordinary partners are liable for the contractual obligations of the investment partnership assumed in relation to commercial parties to the extent of the value of their respective contributions to the partners' common property. If the common property is insufficient, the managing partners bear subsidiary liability for such obligations of the investment partnership on a joint and several basis. Any agreement of the parties to the IPA purporting to exclude or limit the partners' liability as described above will be null and void.

2.2 Regulation of fund raising and fund managers

The following laws and regulations govern the manner in which private equity funds can be marketed and operated in Russia:

- the Investment Funds Law provides the legal framework for establishment and operation of joint stock investment funds and unit investment funds. The Investment Funds Law specifies requirements for investors, management companies and investment funds, procedure of formation, reorganisation and liquidation of investment funds, rules of circulation of equity interests, raising of funds and other basic issues connected with the activity of investment funds;
- Federal Law No. 208-FZ 'On joint stock companies' of 26 December 1995 (the Companies Law) regulates issues concerning establishment, reorganisation and liquidation of joint stock companies, their legal status, and the rights and obligations of their shareholders. The provisions of the Companies Law are applied in relation to joint stock investment funds subject to the specific requirements of the Investment Funds Law;
- the Investment Partnership Law, in compliance with the Civil Code of the Russian Federation, regulates investment partnerships;

- various regulatory acts of the CBR, which is the federal executive body in charge of the securities market; and
- various regulations of the Federal Financial Markets Service (FFMS; although the FFMS has ceased to exist and its authority has been transferred to the CBR, its regulations continue to apply) specify requirements for investment funds, including but not limited to: (i) composition and structure of assets of private equity funds (FFMS Order No. 1910-79/pz-n08); (ii) the amount of a joint stock investment fund's own resources and procedure for their calculation (FFMS Order No. 09-32/pz-n of 13 August 2009); (iii) the minimum value of property which constitutes a closed unit investment fund (FFMS Order No. 125/pz-n of 2 November 2006); and (iv) additional requirements for preparation, convocation and holding of a general meeting of the holders of equity interests (FFMS Order No. 08-5/pz-n of 7 February 2008).

The following laws and regulations govern the management of private equity funds in Russia:

- the Investment Funds Law stipulates requirements for the management company, its rights, obligations and responsibilities, certain rules concerning remuneration of the management company and restrictions on its activities;
- various regulations of the FFMS specify certain requirements for the management companies of investment funds, including but not limited to:
    - the requirements as to the amount of own resources of the management company (FFMS Order No 11-23/pz-n of 24 May 2007);
    - the requirements as to the procedure for determining the amount of remuneration of the management company (FFMS Order No. 08-31/pz-n of 29 July 2008);
    - the requirements for the employees of the management company, internal control of the management company and recording of the property transferred in trust management (FFMS Resolution No. 13-25/ps of 9 April 2013); and
    - the procedure, terms and requirements for obtaining licences by management companies (FFMS Order No. 10-49/pz-n of 20 July 2010 and the FFMS Order No. 11-5/pz-n of 25 January 2011).

Pursuant to Russian law, the management company of a private equity fund can be only a joint stock company or a limited liability company incorporated under the legislation of the Russian Federation. The management company is entitled to carry out its trust management activities only on the basis of a licence issued by the CBR.

In case of revocation of the management company's licence, the rights and obligations of such management company under the trust management agreement shall be transferred to another management company within three months from the date of revocation, otherwise the private equity fund shall be terminated.

Under Russian law the management company is not entitled to simultaneously manage and own the property of the private equity fund. Therefore the management company is required to transfer the fund property into the custody of a licensed Russian custodian (depositary).

2.3 Customary or common terms of funds

Russian law provides for the following key terms and requirements for domestic private equity funds:

- private equity funds established in the territory of the Russian Federation may be in the form of a joint stock investment fund, a closed unit investment fund or an investment partnership;
- private equity funds organised in the form of a joint stock investment fund, as well as the management company of private equity funds, are entitled to carry out activity only on the basis of a licence issued by the CBR;
- the own resources of a private equity fund in the form of a joint stock investment fund as at the date of submitting documents for receiving a licence shall be not less than RUR 35,000,000 (about EUR 750,000);
- the minimum value of property which constitutes a private equity fund in the form of a closed unit investment fund is RUR 25,000,000 (about EUR 535,000);
- the assets of private equity funds may include only the following property:
  - monetary funds in the currency of the Russian Federation on accounts and deposits at credit institutions;
  - debt instruments, including those issued by Russian business entities, more than 25 per cent of the placed shares or participatory interests of which are assets of the private equity fund;
  - shares of Russian joint stock companies and/or participatory interests in limited liability companies;
  - bonds of Russian business entities, if more than 50 per cent of the placed shares or participatory interests of such entities are the assets of the private equity fund; or
  - bills of exchange of Russian business entities if more than 50 per cent of the placed shares or participatory interests of such entities are the assets of the private equity fund;
- the assets of a private equity fund shall not include shares of Russian joint stock companies and/or participatory interests in limited liability companies being placed (acquired) at their foundation; and
- the term of trust management agreement in respect of the unit investment fund shall be not less than three years and not more than 15 years starting from the date of its formation.

3. DEBT FINANCE

3.1 Means of financing

Leveraged buyout transactions are not very common in Russia but, as noted above, debt finance is very often part of the medium-term development

plan for a portfolio company which will be initiated by the private equity investment.

Financing in the form of a traditional secured term loan facility remains the predominant form of financing in Russia. Loan facilities are generally extended by banks, and the major state-owned Russian lenders, VTB, Sberbank and Vnesheconombank, have become prominent lenders in recent years as the major international banks have to some extent retrenched from lending in Russia following the global financial crisis.

Usually, a loan is extended under a bilateral facility agreement using the template employed by the particular lender. No common template is widely recognised in the Russian debt market, although the use of English-law documentation in line with Loan Market Association (LMA) standards is common, even among the major Russian banks which frequently lend through offshore subsidiaries.

Bonds are used much less frequently than bilateral facilities. Bond issuance tends to be used by mature companies with predictable cash flows rather than the growing companies which are typically the target of private equity deals in Russia. Further, bond issuances are subject to a more restrictive regulatory regime than facility agreements. High yield bonds are rarely used in the context of private equity investments in Russia.

Until recently, securitisation was limited solely to debt securities secured by mortgage portfolios. However, new regulations in respect of securitisation have recently been introduced which broaden the asset classes that may back the securities issued, and it is expected that securitisation will become more widespread in Russia. This may offer an alternative to a standard loan facility for portfolio companies within certain sectors, notably energy and technology.

3.2 Restrictions on granting security

No general restrictions limiting the grant of security exist in Russia, and lenders usually secure loans by pledges over assets and shares.

However, if a lender, whether through voting powers in respect of shares or otherwise, can control a company whose shares are pledged, antimonopoly clearance may be required for the grant and/or enforcement of the pledge.

Further, if a lender is a foreign person (company or natural person) or is directly or indirectly controlled by a foreign person, the grant and enforcement of the pledge may require the consent of the authorised governmental bodies under the Strategic Investment Law. Such consent may be required if the company that has pledged its shares is a strategic company. A company is treated as strategic if it conducts any of the activities listed in the Strategic Investment Law or holds a land plot of national importance.

A pledge may be challenged if entered into in anticipation of the insolvency of the pledgor. This risk needs to be carefully considered by lenders as Russian law specifies a wide list of situations when a pledgee is deemed to be aware of the weakened financial position of a pledgor.

3.3 Inter-creditor issues

The lack of regulation of inter-creditor priority, together with imperative provisions of the Civil Code envisaging priority of pledgees on a strict chronological basis, used to be one of the key challenges for structuring complicated financial transactions. However, the Civil Code has recently been amended to address this issue and the priority of pledgees can now be changed by agreement between the pledgees (or between the pledgees and the pledgor). However, these new provisions of the Civil Code have not yet been tested in any cases and there is a risk that the Russian courts may take a restrictive approach to their interpretation.

Subordinated loans are expressly permitted by Russian law only for credit organisations acting as borrowers. An unsecured loan granted to a company which is not a credit organisation will be treated pari passu with all other unsecured loans if insolvency proceedings against the borrower are commenced.

The priority of creditors in the course of insolvency is strictly regulated by Russian law. Different rules apply to the insolvency of credit organisations and certain other companies, but generally individuals and employees enjoy priority over other creditors. Claims of a pledgee will be satisfied from the proceeds of sale of the pledged property, but in an amount not exceeding 70–80 per cent of such proceeds (depending on the secured obligations).

3.4 Syndication

Whilst syndication does exist and its use has been developing in recent years, the syndicated loans market remains relatively small in the Russian Federation for both commercial (absence of risk-management standards appropriate for syndication) and legal reasons.

Regulation of syndicated loans is underdeveloped, although the CBR has recently revisited its regulations in that regard and its new rules are more in line with standard international market practice. However, the new CBR syndication regulations have not been tested by the courts and there are still a number of grey areas (for example, whether a majority of creditors may compel the minority to accelerate the loan; whether a creditor may enforce its rights in contradiction to the definitive agreements; and whether an agent may act on behalf of all the creditors in the course of insolvency proceedings and enjoy the rights of a secured creditor).

The lack of standard Russian documentation for syndication and sub-participation leads lenders to use LMA forms, which are not entirely consistent with Russian legislation.

4. EQUITY STRUCTURES

4.1 Role of management

The majority of private equity investment in Russian companies operates on a joint venture model. The founding shareholders will continue to hold equity (typically a controlling stake) in the portfolio company, usually through an offshore corporate vehicle, and will be party to a shareholders' agreement with the private equity investor(s). Board representation for the

managers is likely to be derived from the equity ownership of the founding shareholders (and reflect the founding shareholders' controlling stake) rather than specific rights in their capacity as managers.

The wider management team would not usually be given equity directly in the investment company (whether in the Russian operating entity itself or any offshore holding company), but may hold shares in the founding shareholders' investment vehicle. However, to align the interests of the management team with the shareholders, it is common for there to be a performance-related bonus scheme. This may take the form of a phantom equity arrangement, whereby the managers are entitled to a percentage of any uplift in the value of the company based on a deemed equity holding. Alternatively, a formula-based remuneration scheme linked to the achievement of key investment milestones or the internal rate of return (IRR) achieved by the private equity fund may be used.

Management would usually be employed under Russian law employment contracts, the terms of which are closely prescribed by Russian law.

The key management appointment in any Russian company is the general director (CEO), who has extensive management authority under Russian law, including the ability to conclude transactions on behalf of the company and sign agreements binding the company without any additional authorisation (except as stipulated by the company's charter) or any power of attorney. The controlling shareholder is likely to insist on having the right to nominate the general director, but an investor with a significant minority stake will want to ensure that the shareholders' agreement puts in place appropriate checks and balances on the general director's authority.

4.2 Common protections for investors

Protections will vary depending upon the size of the shareholding to be acquired by the private equity investor, but will typically include:

- board representation – the investor would expect at least one director. Note that in the case of direct investment in a Russian joint stock company, cumulative voting will apply for board appointments and the appointments procedure will need to take this into account;
- veto rights – a requirement for investor consent to specific actions should be documented in any shareholders' agreement and hardwired into the Russian operating company via its charter. Veto rights would range from blocks on fundamental changes to the company's business or actions that may result in value leakage (for an investor with a sub-20 per cent holding) to some involvement in material operational matters (where the investor has a 25–50 per cent holding);
- limits on the authorities of key personnel – constitutionally, in employment contracts or through some form of 'two key' approval system. For a majority or significant minority investor, there may also be a hardwired right to appoint or at least remove the general director (CEO), the chief financial officer (CFO) and other key personnel, which rights should be enforceable and backed by hard commitments;

- transfer provisions – lock-in applicable for agreed investment period, rights of first offer/refusal on share transfers, tag-along right (for minority shareholders) and drag-along right (for majority shareholders). Put and call options may apply (typically at a discount to fair value) in the event of a default by a shareholder (eg change of control or material breach of the shareholders' agreement). Private equity investors need to be aware of the potential for transfers to be frustrated by requirements to obtain regulatory consents (from the Federal Antimonopoly Service and under the Strategic Investment Law);
- information rights – rights to receive audited accounts, monthly management accounts and other key information, particularly information required to enable the private equity fund to make required disclosures to its own investors. The private equity investor may also have the right to appoint the CFO as a means to access information at operating level. Investors will also normally insist upon the appointment of a 'Big 4' auditor; and
- adequate recourse against the founding shareholders for breach of commitments through guarantees, pledges and rights over depositary accounts.

The investor should be prepared for the possibility that there will be deadlock or the partner will turn hostile in the future. In addition to economic alignment, solutions are a clear secured exit (put or put–call if it is realistic that the partner could ever be a forced seller) and possibly the right to syndicate to bring in a third party investor who could calibrate the position with the partner.

The way that value is stripped out of Russian companies is through contracts with related parties, transfer pricing schemes and remuneration. All of these need to be tightly controlled with vetoes and rights of appointment/removal over key personnel, backed up by strong financial controls (and, for example, a financial controller or a 'two key' system in respect of certain matters). The consequences for breach need to be loss of economic alignment and triggering of secured exit rights (or lawful penalties in lieu).

Items like business plan, respective obligations (including OPEX and CAPEX), the path to exit (IPO, buyout, trade sale), dividend policy and outside financing expectations need to be clearly agreed at the outset.

4.3 Common protections for management

To the extent that the managers are also the founding shareholders and hold equity in the portfolio company, they will enjoy the same protections as described for the investor. In addition, if the founding shareholders maintain a controlling stake in the company, they will seek protections to ensure that they have full operational control at the Russian level. The founding shareholders will wish to keep the powers of the general director (if such person is appointed by them) as unrestricted as possible. The balance between the founding shareholder's operational control and the investor's veto rights is often a critical negotiating issue, particularly where returns for

the founding shareholders have a performance-related component (eg the right to retain an above-pro-rata share of profit once the investor's IRR has been achieved).

Save where they act in the dual capacity as managers and shareholders, management will not usually be given any specific protections other than rights under employment contracts and any bonus-plan agreements.

4.4 Management warranties

The investor would expect to be given comprehensive business warranties from the founding shareholders. Warranties regarding title to shares and assets, tax, accounts, permits/licences (depending on the sector) and litigation are all critical. Managers who are not also founding shareholders would not generally give any warranties to the investor. Limitation periods for warranty claims are typically up to three years for title and tax claims, and from one to two years for all other warranty claims. De minimis (individual and basket) thresholds and caps are commonplace.

4.5 Good leaver/bad leaver provisions

As noted above, it is rare for the wider management to be given equity in the portfolio company and, as such, management departures do not usually trigger any obligations regarding equity transfers. However, it is fairly standard for the bonus scheme applicable to management to include good leaver/bad leaver provisions. The grounds for dismissal of an employee are heavily circumscribed by Russian law and, as such, there can be a conflict with the bonus scheme agreements, which will seek to make 'bad leaver' a much broader concept.

4.6 Public to private transactions

Public to private transactions are rare in Russia, but any such transaction would need to comply with the takeover rules under the Companies Law.

A mandatory offer must be made to the target company's shareholders to acquire all other voting shares in an open joint stock company, and securities convertible into such shares, at their market price when a bidder acquires more than 30 per cent (as well as over 50 per cent and 75 per cent) of the target company's shares.

A bidder is entitled to squeeze out the minority shareholders of an open joint stock company if both: (i) the bidder demanding the squeeze-out owns more than 95 per cent of the total number of the target company's shares (together with its affiliates); and (ii) at least 10 per cent of the shares owned by the bidder were acquired through a mandatory or voluntary public offer.

The consent of the Federal Antimonopoly Service is likely to be required for any acquisition. Depending on the sector in which the target company operates, consent under the Strategic Investment Law may also be required.

5. EXITS

5.1 Secondary sales

Secondary sales (the sale by a private equity fund of one or more portfolio companies to another private equity fund or financial institution) have not been, and are not, very common in Russia.

5.2 Trade sales

Trade sales, to either financial or strategic investors, are the most commonly used means of exit in Russia.

Lock-in periods are commonly included in shareholders' agreements between founders and private equity investors, often in the range of 3–5 years. There is often a reasonable endeavours obligation on the parties to work towards an exit (third party sale or IPO) after that date and, in the absence of such exit, the private equity investor would be free to sell its stake subject to any applicable transfer restrictions.

Rights of first refusal or first offer are often included in the shareholders' agreement and, for a minority shareholder, a sale to a majority shareholder who wishes to assume sole control may represent the most viable exit.

Tag-along rights and drag-along rights are common, so if a majority shareholder elects to exit this will usually result in a 100 per cent disposal.

The private equity investor is not normally excluded from the obligation to give warranties to a third party purchaser on an exit, save in situations where it is compelled to sell pursuant to an exercise of a drag-along right (in which case only title warranties are usually expected).

5.3 IPOs

IPO exits are frequently contemplated by shareholders' agreements for private equity investments but are rarely realised. Whilst there have been two notable recent IPOs of companies with private equity investment (Lenta and Tinkoff Credit Systems), trade sales are likely to remain the primary exit mechanism for private equity investments.

5.4 Refinancings

Refinancing as a means of exit is not commonly used by Russian private equity funds.

5.5 Restructuring/insolvency

Restructuring/insolvency as a means of exit is not generally used by Russian private equity funds.

6. TAX

6.1 Taxation of fund structures

As described above, trade sales are the most common exit strategy in the Russian private equity market.

The Russian tax system does not include an express capital gain tax. Investors' capital gains on a sale of shares are subject to corporate profit

tax (20 per cent) or personal income tax (13 per cent tax for residents/30 per cent tax for non-residents), depending on whether the taxpayer is a corporation or an individual. Capital gains on shares are not subject to VAT or other special transaction taxes.

Unit investment funds and investment partnerships are not separate legal entities and are tax-transparent so that, for tax purposes, all income (including exit proceeds of any investment) is received at the investor level only. A joint stock investment fund is a separate taxpayer and has a two-tier taxation structure, which means that the fund first pays tax upon exit from portfolio companies and then investors pay tax upon exit from the fund. This makes a joint stock investment fund less attractive from a tax perspective.

The corporation tax regime applicable to capital gains derived by resident entities and foreign entities which carry out business activity in Russia through a permanent establishment (should such capital gains be attributed to the Russian permanent establishment's activity) is the same.

The general rule is that the tax base is determined as income from the sale or redemption of shares less deductible expenses (acquisition expenses, brokerage and management fees). It is important to note that, for tax purposes, the income from the sale of shares is not always determined as being equal to the agreed sale price. This is primarily relevant for shares which are not publicly traded, the price of which for tax purposes is determined as capital per share. Tax obligations should be fulfilled through a self-assessment mechanism (quarterly submission of tax returns).

Capital gains from the sale of shares in either Russian investment funds or companies which are received by foreign legal entities not operating through a Russian permanent establishment (or where the capital gain is not attributable to such permanent establishment) are exempt from (withholding) taxation unless more than 50 per cent of the disposed fund's or company's assets is represented by Russian real estate. In some cases this national limitation to the general exemption rule may be overridden by the application of a double tax treaty. However, most double tax treaties are now being renegotiated in order to close this loophole and bring them into compliance with national tax rules. Note also that the above exemption applies only to capital gains from sales of shares and does not cover the redemption of shares, which is taxed at source (withholding taxation) at a standard rate of 20 per cent.

Capital gains derived by individual investors are taxed in the same way as those derived by corporations except that overseas individual investors are not entitled to exemption of capital gains through a double tax treaty (unlike corporate investors).

A number of funds provide for interim payments, which are treated as non-operational income and are usually taxed on a cash flow basis. Russian tax rules provide for a special dividend tax rate, which is 9 per cent for residents and 15 per cent for non-residents (corporates and individuals). If dividends are paid to overseas investors, the rate of taxation may be reduced or eliminated subject to application of a double tax treaty.

Considering the above, it may be more tax advantageous to invest in Russian funds and companies through foreign special-purpose vehicles (SPVs). This investment structure can not only eliminate withholding taxation of capital gains in Russia, but can also decrease the overall tax burden on the return on investment. However, the use of an SPV, and the choice of jurisdiction in which to incorporate such SPV, will need to be carefully considered in view of the controlled foreign company legislation expected to be introduced in the Russian Federation during 2014 and to be effective from 2015.

6.2 Carried interest

Russian tax law does not recognise carried interest as a special type of income and does not provide for any special taxation rules in this regard. The management company will pay corporate profit tax on carried interest and/or other types of management fees in case of a mixed fee arrangement. For tax purposes, carried interest is treated as regular operational income of an investment manager and is subject to corporate profit tax at a rate of 20 per cent.

6.3 Management equity

Specific tax aspects related to the equity that is awarded to management usually arise in closed funds, where the investment declaration allows the transfer of non-monetary assets to the management. Despite the fact that the fund property is managed on behalf of the investors, the management company is liable to pay VAT and substantive taxes (eg property tax and land tax) in respect of the managed property. Special rules with respect to payment of property tax and land tax at the level of the management company have been introduced in order to prevent tax avoidance schemes whereby assets are transferred to a captive fund (usually a closed unit investment fund) in order to avoid taxes. The relevant taxes are paid by the management company on behalf of the equity holders.

6.4 Loan interest

Under the general rules, loan interest (if paid to an overseas lender) is subject to withholding tax at a rate of 20 per cent. In certain cases, the withholding tax may be eliminated or reduced by the application of a double tax treaty.

Loan interest payable to a Russian entity would not be subject to withholding tax.

Generally, interest is deductible by the payor as long as it does not deviate by more than 20 per cent from the market interest rates paid on comparable loans in the same calendar quarter (for example, if the market rate is 10 per cent, the deviation corridor is 8–12 per cent). Any excess interest is not deductible. If comparable loans do not exist (or if a taxpayer so elects), interest is deducted within certain limits: at the CBR's refinancing rate for rouble-denominated loans; and at a flat rate for loans denominated in a foreign currency. This rule will apply until 2015; from 2015 onwards,

interest on loans between unrelated enterprises may be deducted without limitation.

Note that, in respect of a unit investment fund, Russian legislation prohibits a management company from entering into a loan or other credit facility arrangement save where the management company lacks the funds for redemption of the equity interest. In this case, a short-term debt financing may be obtained (for a term of not more than six months) and the overall amount of such financing must not exceed 20 per cent of the unit investment fund's equity capital. This restriction does not affect joint stock investment funds or investment funds with limited circulation shares.

6.5 Transaction taxes

As mentioned above, Russian legislation does not provide for any special transaction taxes (such as a financial transaction tax or similar).

7. CURRENT TOPICAL ISSUES/TRENDS

Deoffshorisation

Historically, the preference has been for investments in Russian assets to be structured via an offshore holding company in a jurisdiction with a favourable double tax treaty with Russia and which permits the putting into place of an English law shareholders' agreement (including the typical bespoke international protections). The investor would then seek to 'hardwire' the protections granted at the offshore level in the Russian operating company through amendments to the charter.

However, the 'deoffshorisation' agenda signalled by President Putin in 2013, including the impending introduction of controlled foreign company tax rules, seems likely to lead to significant changes in transaction structuring. The trend towards onshore investment will undoubtedly also be accelerated by the recently imposed EU and US sanctions in relation to Ukraine, and the desire of Russian parties to avoid any of their assets being blocked in the future.

Investors are likely to be under increasing pressure to make investments directly into Russian portfolio companies under Russian law (rather than through an offshore SPV). Russian corporate law has improved significantly in recent years (eg permitting the use of shareholders agreements in respect of Russian companies and moving to introduce warranties and representations), so this is not as problematic as it once may have been. However, Russian law does not yet offer the flexibility of an English law shareholders' agreement and workarounds are likely to be developed to find a way to provide international protections in the context of an onshore deal (eg holding Russian equity through a depositary so that a foreign law shareholders' agreement can be used).

Funding

The EU and US sanctions on certain Russian individuals and companies imposed in March 2014 are likely to result in a 'pause' in new investments from the EU and the US. In any event, the major Western private equity

funds (with some exceptions) have not been significant investors in Russia in recent years, and the private equity funds of the state-owned banks (VTB and Sberbank) and RDIF (the Russian sovereign wealth fund), as well as the portfolio investment divisions of the oligarchic groups, have tended to be the dominant players.

There has been a developing trend towards a co-investment model, with non-Russian private equity investing alongside Russian funds and benefiting from their market knowledge and local execution abilities. RDIF is notable in this regard as its strategy is expressly based on co-investment and attracting at least matching funding for each investment in a portfolio company.

This co-investment seems likely to continue, although perhaps with a geographical shift in the pool of investment capital. Funding from Asia and the Middle East seems likely to figure more prominently, reflecting the increasing economic strength of these regions and the pivot towards Asia that has been signposted by the Russian government. RDIF's funds established with China Investment Corporation, Korea Investment Corporation, Mubadala Development Company and Abu Dhabi's Department of Finance may be suggestive of how the investment landscape will look in the near future.