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Fédération de Russie

Pour une politique de l'investissement plus transparente

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Foreword

The Review, a follow-up to the 2004 investment policy review of the Russian Federation, has been undertaken under the aegis of the OECD Investment Committee as a part of its co-operation programme with the Russian Federation. The European Commission has provided financial support for this work.

The Review benefited from close co-operation with the Russian authorities, especially Mr. Kirill Androsov, Deputy Minister, Ministry of Economic Development and Trade, and Mr. Andrei Kozlov, First Deputy Chairman of the Central Bank, who headed the high level delegation at the peer review by the Investment Committee held on 11 April 2006 in Paris.

*The business community and market practitioners also contributed to the preparations of the Review, in particular the Association of European Businesses (AEB), the OECD Business and Industry Advisory Committee (BIAC), the Association of Russian Banks, foreign-owned banks and securities firms and the Russian National Association of Securities Dealers. The analysis of regional aspects draws on discussions with Russian regional representatives and business associations in a workshop organised by the OECD in St. Petersburg in November 2005.**

The Review is based on a background report prepared by Blanka Kalinova, Senior Economist in the Investment Division of the OECD's Directorate for Financial and Enterprise Affairs, with input from consultants for the Division: Catriona Patterson and Eva Thiel who contributed chapter 5 and chapter 6 respectively, and James Beadle who undertook the OECD business survey in Russia. Celine Schwarz provided statistical support. Pamela Duffin is the Division's communication officer.

The Review is published under the responsibility of the OECD Investment Committee.

* The cut-off point for information in this report is 1 June 2006.

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Prefaces

This Review is part of long-standing co-operation between the OECD and the Russian Federation aimed at fostering mutually beneficial dialogue and supporting Russia's efforts to strengthen its policies in line with OECD best practices and instruments. In examining recent developments in Russia's regulatory environment, the Review highlights challenges and progress in investment policy and capital control liberalisation, with a focus on policy transparency. It encourages open and transparent implementation of recent initiatives such as the creation of special economic zones and upcoming legislation on the so-called strategic sectors. Enhancing the policy framework for investment will allow Russia to attract more and better international investment, stimulating sustainable growth and economic modernisation.

Throughout this Review, the OECD Investment Committee has sought to play an effective supporting role by offering a forum for sharing experiences among Russian and OECD government officials and engaging the business community and other stakeholders on the range of emerging investment policy issues. This interaction has also been conducive to closer compatibility between Russia's investment regulations and the standards embodied in the OECD Code of Liberalisation of Capital Movements and the Declaration on International Investment and Multinational Enterprises.

On behalf of the Investment Committee, I would like to thank the Government of the Russian Federation, especially the Ministry of Economic Development and Trade and the Central Bank of Russia for their active involvement in this work and distinctive contribution to the investment policy review of Russia by the Investment Committee in April 2006 in Paris on which this publication is based.

Manfred Schekulin
Chair, OECD Investment Committee

On behalf of the Ministry of Economic Development and Trade of the Russian Federation, I would like to express our appreciation of the fruitful collaboration with the Organisation for Economic Co-operation and Development on investment policy issues, which this Review further confirms and strengthens.

The Review recognises significant progress by the Russian Federation in improving the investment climate and attracting foreign investment and also points to remaining shortcomings and obstacles which still prevent our country from becoming a major recipient of international investment. By putting our achievements in an international perspective and comparing our investment policies with OECD countries' good practices in this area the Review and policy dialogue contribute to identifying main priorities and adopting adequate measures to enhance the role of foreign investment in Russia's economic development. As indicated by the Review several initiatives recently undertaken by the government have aimed to encourage the participation of domestic and foreign investors, in particular the creation of special economic zones and introduction of public-private partnership in infrastructures. We share the view that the success of these schemes as well as the role of the upcoming legislation on strategic sectors will greatly depend on the transparency of the relevant regulatory framework and its implementation.

I consider the Review of the Russian Investment Policy to be an important step in our co-operation with the Organisation and hope that it will be actively pursued, thereby reinforcing our partnership and participation within the international investment community.

Kirill Androsov
Deputy Minister
Ministry of Economic Development and Trade

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Overview and Recommendations

The **2006 Investment Policy Review** examines developments in Russia's regulatory investment environment since the last OECD Review in 2004. It includes an analysis of capital control reform and a survey of Russia's approach to international investment agreements. In assessing these developments and offering options for further improvements, **policy transparency has been the focus of this Review**.

More international investment is needed to support Russia's economic development and diversification. Since 2003, Russia has attracted increased amounts of foreign direct investment (FDI), which reached record levels in 2004 and 2005. However, the share of FDI in domestic capital formation still remains low by international comparison. In 2005 the manufacturing sector attracted the largest FDI share and the energy sector absorbed one third of inflows, but Russia's service sectors have not yet benefited from significant FDI. Russia's international investment statistics provided by the Central Bank of Russia have been improved in line with OECD standards, but consistency problems between Russian different data sources persist.

Despite progress, the level of restrictions on foreign investment remains above the OECD average. Russia's formal barriers to FDI are high in insurance, electricity and transport, whereas some other sectors such as distribution and business services have been opened up. In addition to equity restrictions, foreign investors face impediments in licensing procedures and other business-related regulations concerning for example foreign personnel. These difficulties are often aggravated by corruption and the lack of predictability.

The OECD Review shows that insufficient policy transparency remains a serious obstacle to investment. Based on an OECD business survey carried out in 2005, foreign investors acknowledged improvements in information access and administrative simplification in a number of areas, such as foreign exchange regulations, but expressed concerns about non-transparent implementation in other fields, often under the responsibility of regional administrations, including land and property registration and work permits. The business community also finds prior consultation on regulatory changes insufficient. Improved policy transparency would naturally limit opportunities for corruption, which has been identified as a major impediment to investment in a number of other recent business surveys.

New laws on Special Economic Zones (SEZ) and Concessions can have a positive impact on investment. Costly investment promotion efforts and targeted investment incentives have not been effective in helping regions attract more foreign investment. The new laws could allow regions to exploit their potential comparative advantages better if they are implemented in a non-discriminatory and transparent manner, with a minimum of market distortion. A regulatory impact assessment of these programmes would be desirable, especially given the past experience with SEZ in Russia.

The forthcoming laws on "strategic sectors" and on subsoil will be a test of the government's commitment to transparency. Consistent with best practice under the OECD instruments, the Review recommends that the future strategic sector law narrowly defines the sectors concerned, limits the scope of restrictions to foreign control over domestic companies based on a strict interpretation of essential security interests, and clarifies the modalities of government review and permission procedures, in particular, by establishing specified time limits for notifications of government decisions to the applicants.

The Review welcomes the abolition of certain capital controls on 1 July 2006, in advance of the schedule of 1 January 2007 initially foreseen by the 2004 Foreign Exchange Law. Financial market participants have considered the system of capital controls too complex, insufficiently transparent, often ineffective and costly for both foreign and domestic investors. Consistent with the OECD instruments, the orderly removal of capital controls needs to be accompanied by supporting measures, including statistical reporting, appropriate tax control, anti-money laundering and non-discriminatory prudential safeguards. The Review encourages efforts to improve information sharing among the regulatory bodies of financial markets in Russia.

The Review invites continued efforts to enhance investment policy transparency. It welcomes the planned reduction of activities subject to mandatory licensing and the establishment of a Register of regional and municipal legislation. It encourages a speedy adoption of the new law on access to information submitted by the government in 2005. The Review recommends more effective and systematic consultations with interested parties, publishing and reviewing administrative decisions, and using electronic dissemination of investment regulations more extensively. It suggests the application and disclosure of regulatory impact assessments for special investment incentives regimes. The Review also encourages the inclusion of strong transparency disciplines in Russia's future international investment agreements.

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Chapter 1

Russia's International Investment Trends and Policies: A Comparative Perspective

Despite its recent expansion, the volume of Russia's international investment, including foreign direct investment (FDI), portfolio and trade credits remains modest compared with major OECD countries. After several years when outward FDI flows were equivalent to or larger than inward flows, Russia became a net FDI importer in 2004. However, the recent upsurge of inward FDI has not yet translated into a significant share of FDI in GDP and total investment. Whereas manufacturing attracted 45 per cent and the energy sector absorbed one third of total inward FDI in 2005, the service sector has not yet benefited from significant FDI.

According to OECD's foreign direct investment restrictiveness index, Russia's overall level of openness to investment is below the OECD average. Whereas some sectors, such as business services, distribution and tourism, are relatively open, foreign equity ceilings and restrictions on foreign personnel in some other sectors, in particular financial services, transport and electricity, are still high.

1. Russia's recent international investment developments

1.1. Overall international investment into Russia is increasing but the volume of foreign direct investment is still modest

Russia's overall cross-border financial flows (direct, portfolio and other investments) have considerably expanded since 2003 but their overall volume remains low compared with major OECD countries. In contrast to OECD countries, in which portfolio investment is generally the most important part of inward and outward flows (representing between a third and half of aggregate investment),[1] this component has been so far relatively negligible in Russia and net portfolio flows were even negative in 2003 and 2005. Russia's investment flows are dominated by other investment, consisting mainly of financial transactions and trade credits and loans (66 per cent of aggregate investment flows in 2005), which attests in particular to significant external borrowing by domestic banks and enterprises (Table 1.1).

Table 1.1. **Russia's international investment inflows and outflows, 2001-2005**

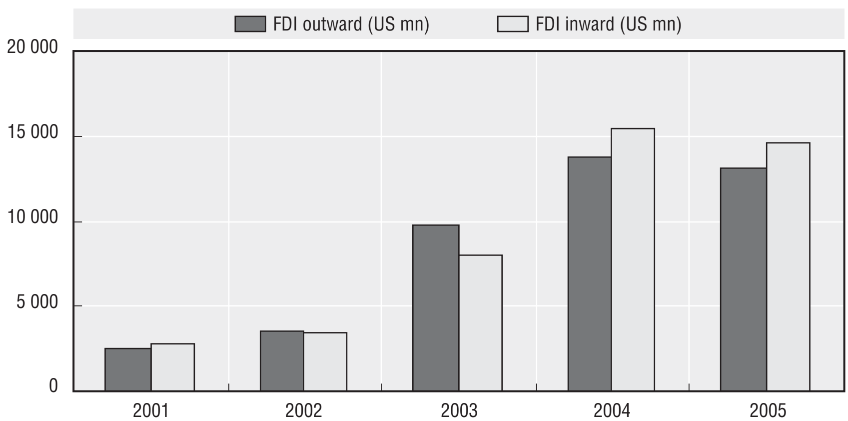
In USD million

	2002	2003	2004	2005
Total outward investment flows	6 449	27 259	42 892	54 631
Of which:				
• Direct investment	3 533	9 727	13 782	13 126
• Portfolio	796	2 180	4 257	10 666
• Other investment	2 120	15 352	24 853	30 839
Total inward investment flows	3 433	28 274	37 530	56 091
Of which:				
• Direct investment	3 461	7 958	15 444	14 600
• Portfolio	3 756	–2 329	4 406	–854
• Other investment	–3 784	22 645	17 680	42 345
Memorandum item				
Inward FDI stock at the beginning of the period	52 919	70 884	96 729	117 891

Source: Central Bank of Russia, Balance of Payments Statistics.

After quasi-stagnation in 2000-2002, inward foreign direct investment flows more than doubled in 2003 and increased at the almost same pace in 2004. This trend allowed Russia to become a net FDI importer in 2004 (Figure 1.1). Available data provided by the Central Bank of Russia (that diverge from the figures reported by the Federal State Statistical Service – see Box 1.1) show a slowdown in Russia's FDI inflows in 2005 compared with the previous year, due mainly to a major withdrawal of equity capital from Russia in the fourth quarter of 2005. At the same time, the high share of reinvested earning (66 per cent of FDI inflows into the non-financial sector in 2005) seems to indicate the interest of established investors in expanding their activities in Russia. In 2005, Russia's total inward FDI stock exceeded the amount of USD 100 billion.

Figure 1.1. **Annual FDI flows to and from Russia**



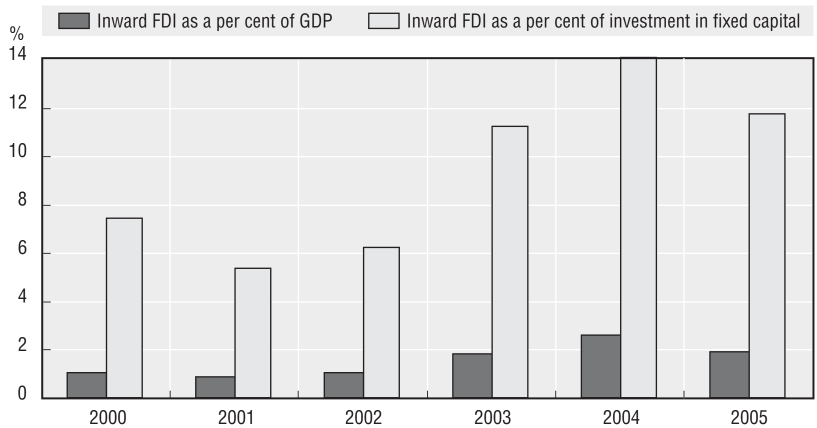
Source: Central Bank of Russia, Balance of Payments Statistics.

FDI measured as a percentage of GDP can serve as a proxy for evaluating the relative importance of foreign direct investment in cross-country analyses. Russia's share of FDI inflows in GDP has increased since 2003, but in relative terms it remains still low compared to most OECD countries and emerging economies. For example, in 2004, the share of inward FDI in Russia's GDP was the same as for the Ukraine (2.6 per cent) and less than half that of Poland (4.9 per cent). Although it has grown rapidly in recent years, the share of FDI in Russias investment in fixed capital is also relatively limited (see Figure 1.2).

1.2. Product and geographical structure of FDI evolves but not sufficiently

According to Russian data provided by the Federal State Statistical Service, which is the unique source for sectoral data and breakdown by main investor partners (see Box 1.1), all sectors benefited from increasing FDI inflows between 2000 and 2005. With more than 40 per cent of annual inflows in 2004 and 2005, manufacturing dominates Russia's FDI, followed by the energy sector, which absorbed approximately one third of annual FDI inflows. In contrast to general trends observed in most countries, including developing countries, marked by a rising share of services in overall FDI, Russia's service

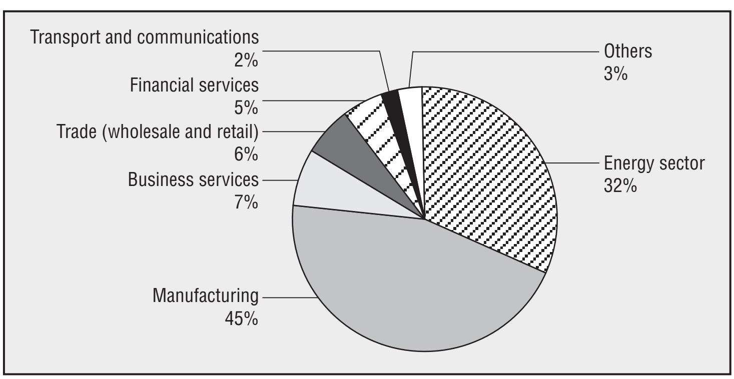
Figure 1.2. **Russia's FDI inflows as a percentage of its GDP and of its investment in fixed capital**



Source: Central Bank of Russia, Federal State Statistical Service.

sector has not so far benefited from large FDI inflows. Moreover, within the service sector, FDI targeting traditional services such as retail and wholesale trade is still more important than inflows to financial services and transport and communications (Figure 1.3).

Figure 1.3. **Russia's inward FDI inflows: share by sector (2005)**



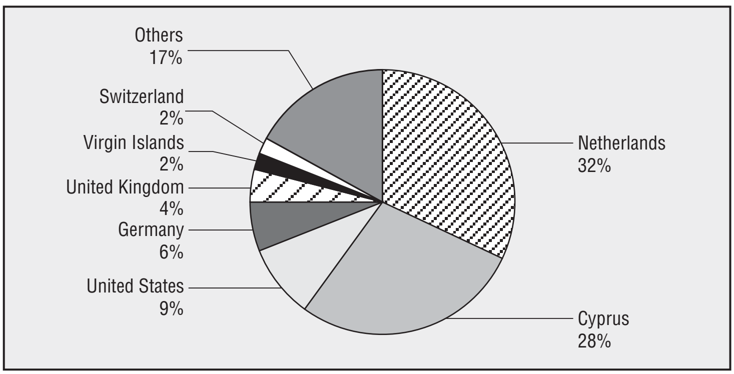
Source: Federal State Statistical Service.

Russia's inward FDI is concentrated on a relatively limited number of partners. By the end of 2005, the two main investors, the Netherlands and Cyprus, represented half of Russia's total inward FDI stock. The position of the Netherlands reflects at least partially its role as a financial centre and investments from Cyprus probably consist, for the most part, of "round-tripping" domestic capital flows, *i.e.* essentially Russian offshore assets reinvested in

Russia. Among other OECD countries, only the US, Germany and the UK figured among leading investors in Russia in 2005 (Figure 1.4).

OECD FDI data for 2003 show the EU-25 as Russia's largest investment partner among OECD countries (67 per cent of total OECD outward FDI stock in Russia), followed by the United States (9 per cent) and Switzerland (7 per cent). Among the EU-25, most FDI flows to Russia came from the Netherlands (32 per cent), followed by Germany (22 per cent) and Austria (15 per cent).[2] According to data reported by OECD countries, within the total portfolio investment of USD 4.8 billion invested in 2003 in Russia, the US represented more than half of this amount, followed by Germany and Luxemburg, each with approximately 14 per cent.[3]

Figure 1.4. **Russia's inward FDI stocks: main partners (2005)**



Source: Federal State Statistical Service.

The recent expansion of international investment inflows to Russia does not necessarily reflect a radical change in investors' perception of the business climate. First, a significant part of FDI is probably constituted by Russian offshore assets reinvested in Russia. Second, foreign investment in the natural resource sector, which is one of the main beneficiaries of foreign investment into Russia, is attracted mainly by high returns and less sensitive to changes in the business climate.

Russia has not yet realised its foreign investment potential and fully used its comparative advantages, which lie not only in its considerable natural resources but also in relatively low wages and a large domestic market. Whereas it is natural that extractive industries continue to attract considerable foreign investment, it is also important to develop backward and forward linkages between the energy sector and the rest of the economy and promote energy-saving investments.[4] Moreover, FDI into the service sector has to increase to boost its productivity, as well as into other sectors which use services as intermediate inputs.

Box 1.1. **Russia's international investment statistics**

Russia has considerably improved collection and dissemination of its international investment statistics, but further progress is warranted, in particular regarding harmonisation of Russia's data with international standard definitions and methodologies and dealing with current statistical discrepancies.

There are two main sources for FDI data in Russia: the Central Bank of Russia (CBR) and the Federal State Statistical Service (FSSS). The CBR data are collected from a balance of payments perspective and serve mainly to analyse the impact of foreign investment on Russia's international financial position. The CBR quarterly and annual balance of payment data differentiate between FDI transactions with the Commonwealth of Independent States (CIS) and non CIS countries and between investment flows of banks and non financial enterprises. In contrast, the FSSS statistics provide a more detailed breakdown by main investor partners' countries and sectoral composition of investment flows. Recurrent divergences in total amount of all three components of foreign investment (FDI, portfolio and other investment) result from different data coverage and sources used by the two institutions to collect their data:

a) The FSSS collects its data through quarterly surveys of non financial enterprises by territorial statistical services. Data cover the gross inflows/ positions of non financial enterprises, but exclude their disinvestment and direct investment transactions/positions of the banking sector.

b) The CBR uses, in addition to the FSSS quarterly data, banks' surveys of resident enterprises and direct reporting by enterprises of their cash transactions made through their foreign bank accounts. Additional information is provided by the Ministry of Economic Development and Trade and the Fund of Federal Property (which records privatisation receipts from non residents).

To reduce the divergences between the two sets of data, which often make difficult the interpretation of investment trends, several steps could be envisaged:

a) Improving the presentation of FDI statistics published by the FSSS, *i.e.* specifying the methodology and data coverage, indicating the dates of the revisions and making the data also available in English on the FSSS website.

b) Comparing the FSSS and the CBR methodologies and data coverage, clearly identifying the reasons for differences in published data and, as much as possible, seek to consolidate the two data sets with the objective of disseminating mutually consistent statistics of Russia's FDI flows and positions.

Box 1.1. **Russia's international investment statistics** *(cont.)*

Russia's agencies should also continue to harmonise their methodologies with relevant international statistical standards and generate data reflecting new international investment developments. The main remaining divergences of the CBR data from international practices concern the treatment of indirectly owned direct investment enterprises and reverse investment as well as the measurement of direct investment earnings. In addition, data on offshore enterprises and special purpose entities do not appear in Russia's investment statistics.[1]

The *OECD Benchmark Definition of Foreign Direct Investment*[2] provides operational guidance on how FDI data should be compiled. It has been regularly updated to make statistical concepts consistent with other related data sets, such as the IMF Balance of Payment Statistics, and with new developments in international investment activities. The Benchmark Definition recommends that countries disseminate FDI statistics broken down by partner countries and by industry classification. The IMF and the OECD have undertaken regular surveys on progress of OECD and non-OECD countries in implementing international statistical standards, including in Russia.[3]

1. Russian Federation: Direct Investment Compilation Practices, Data Sources and Methodology (in use in 2003).
2. OECD Benchmark Definition of Foreign Direct Investment, Third Edition, OECD, Paris 1996.
3. Foreign Direct Investment Statistics: How Countries Measure FDI, 2001, IMF/OECD, 2003.

2. Measuring the restrictiveness of Russia's investment policy

To estimate Russia's progress in liberalising its FDI regime, the Review used the methodology of OECD FDI restrictiveness index.[5] The results for Russia are compared to the updated index of 29 OECD countries and several non-member countries, including Brazil, China and India, which was developed jointly by the OECD Economics Department and the Investment Division.

2.1. Russia's FDI regulatory restrictiveness index

Based on policy measures applied in 2005 in the covered sectors, Russia's overall FDI regulatory restrictiveness index (0.283) is almost double that of the OECD average (0.150) and considerably higher than the score observed in a number of newer OECD members. Russia's FDI liberalisation achievements are also behind those estimated for the non-OECD countries adhering to the OECD Declaration on International Investment and Multinational Enterprises (*i.e.* Argentina, Brazil, Chile, Estonia, Israel, Latvia, Lithuania, Romania and Slovenia). Russia's FDI restrictiveness index compares nevertheless favourably with the scores calculated for India and China (Figure 1.5).

Box 1.2. **Methodology for estimating the FDI regulatory restrictiveness index**

The FDI regulatory restrictiveness index is calculated separately for 9 sectors and 11 sub sectors: *i)* professional services (including legal, accounting, architectural and engineering services); *ii)* telecommunications (fixed and mobile); *iii)* transport (air, road and maritime); *iv)* finance (including insurance and banking); *v)* distribution; *vi)* construction; *vii)* hotels and restaurants; viii) electricity; and ix) manufacturing.*

For each (sub-) sector, three main categories of restrictions are measured:

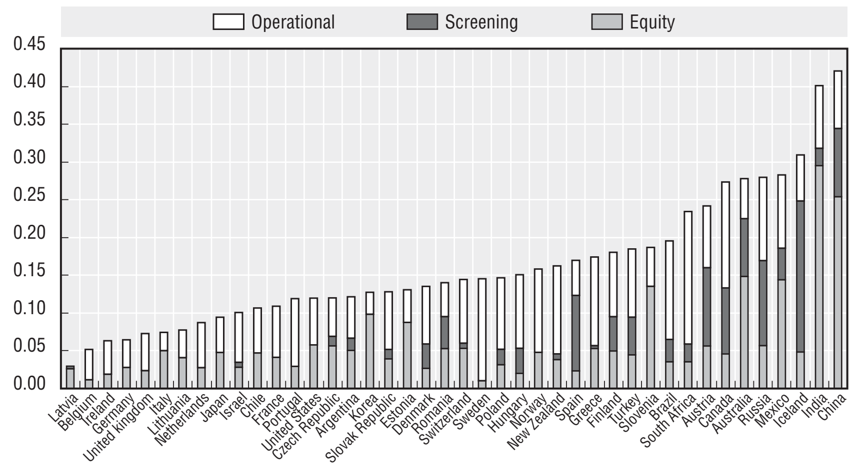
- the authorised level of foreign equity holdings (0-100 per cent); the ownership restrictions are weighted highly given that foreign ownership is a necessary and essential condition for FDI. In line with the adopted methodology, the score is marginally increased if the equity levels in the analysed sectors are not subject to international commitments, as is the case of Russia.
- screening and discriminatory notification requirements;
- other restrictions applicable only to foreign firms, including limitations on foreign participation in boards of directors, on movement of people and other input, and operational restrictions, such as the obligation of domestic content.

The restrictions are evaluated on a 0-1 scale with "0" corresponding to a completely open sector and "1" to a closed sector. Since the limitation on foreign equity is the most restrictive barrier, a ban on foreign ownership in a given sector implies a maximum score of 1 as the other restrictions become irrelevant. As with OECD countries, Russia's overall restrictiveness index is a weighted average of the sectoral indexes using the combination of FDI and trade weights of the analysed sectors.

The methodology evaluates the statutory or formal restrictions directly affecting foreign investors and does not take into account social and institutional measures, which can indirectly and sometimes considerably hamper foreign investment establishment and operations. While most of the examined indicators can be evaluated with reasonable precision for each sector, some others, especially operational restrictions applied across all sectors, are in some cases more difficult to quantify. The exact values of the calculated restrictiveness indexes should be therefore interpreted with caution, but the results nevertheless allow gauging countries' investment barriers and comparing their relative degree across countries.

* To the extent that opportunities for investment in energy, such as oil and gas, vary considerably across countries depending on their natural endowments and in order to avoid biasing international comparisons, energy other than electricity is not among sectors covered by the index.

Figure 1.5. **FDI Restrictiveness index**



Source: Koyama, Takeshi and Golub, Stephen (2006), "OECD's FDI Regulatory Restrictiveness Index: Revision and Extension to More Economies", *OECD Working Papers on International Investment and OECD Economics Department Working Paper*, forthcoming.

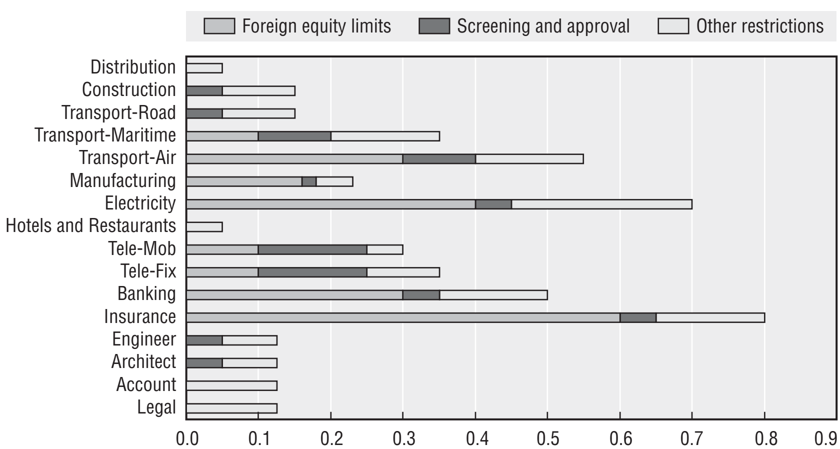
In Russia, equity restrictions are the most important in insurance, electricity, banking and air transport. In insurance, existing legislation does not impose foreign equity limits for individual enterprises but allows the authorities to impose an overall quota of 25 per cent on foreign ownership in the sector as a whole[6]. In the banking sector, the limitation on foreign ownership in the banking system is legally possible though has not seemed to be applied in practice.[7] The presence of foreign banks is allowed only in the form of subsidiaries but not as branches. Foreign ownership in air passenger and fret transport is allowed up to a 49 per cent limit. In most other sectors analysed, in particular business services, hotel and restaurants, construction and distribution, there are no restrictions on foreign ownership.

If excessively restrictive, screening and notification requirements can considerably reduce the value of the otherwise liberal foreign equity access. In Russia, this seems to be the case, particularly in the telecommunication sector where the regulatory authority has considerable discretion to grant, modify or cancel licences. Licensing requirements in transport apply to domestic and foreign firms alike but the complexity of the licensing system may imply selective restrictions against foreign providers. In general, the situation in this area may improve following the government's decision to gradually reduce the number of activities subject to mandatory licensing from 123 to 75.

The FDI restrictiveness index also seeks to capture restrictions affecting the movement of people – such as nationality and language requirements concerning boards of directors and other operational restrictions – which may penalise foreign-owned firms. Russia's current system of business visas could be considered as moderately restrictive given that current legislation[8] stipulates that business visas are issued with a validity of up to 3 months (with single or double entry) or up to one year (multiple entry). However, the OECD investor survey (Figure 1.5) points to significant difficulties met by foreign firms in obtaining work permits for their staff.[9] Among other operational restrictions potentially affecting foreign firms, the most frequent are language, qualification and/or nationality requirements for members of boards or senior managers in insurance and banking, transport and some categories of business services.

Overall, Russia's most restricted sectors are insurance, followed by electricity and air transport. The lowest barriers are observed in hotels and restaurants, distribution and business service (see Figure 1.6). This sectoral pattern is relatively similar to that observed in OECD countries, with the exception of financial services, where Russia's score (0.569) is considerably higher than the OECD average (0.151).

Figure 1.6. **Russia's FDI restrictions: breakdown by sector and type of restrictions**



Source: OECD Investment Division.

The OECD calculations are primarily based on the countries' GATS schedules of commitments and their positions under the OECD Code of Liberalisation of Capital Movements. Such information makes the situation of individual countries not only more transparent but also implies that the countries are subject to internationally binding liberalisation commitments. Since Russia has not yet accepted relevant international commitments, its position as reflected by the FDI restrictiveness index is relatively less transparent and also less predictable compared with other countries. This situation, which exerts an additional adverse impact on foreign investors' decisions, can considerably improve if Russia accepts ambitious liberalisation commitments within its ongoing WTO negotiations.

It is worth noting that the FDI restrictiveness index does not cover all sectors, not considering in particular the primary sector, which is especially important in the context of Russia. Moreover, the methodology used takes into account a limited number of investment barriers and captures only statutory or formal restrictions, leaving aside informal barriers such as non-transparent practices and lengthy or costly proceedings required by different regulations. These latter aspects are generally examined in business surveys.

Notes

1. *Measuring Globalisation – OECD Economic Globalisation Indicators*, OECD 2005.
2. OECD FDI database.
3. *IMF*, *Coordinated Portfolio Investment Survey*: *www.imf.org/external/np/sta/pi/part.asp?iso=RUS*.
4. Investment aimed at increasing energy efficiency should be a priority for Russia. As the ratification of the Kyoto Protocol by Russia has opened investment possibilities in this area, the implementation of concrete projects should not be hampered by the lack of the relevant domestic legal framework.
5. The methodology and initial estimates of FDI restrictiveness index are provided in the Economics Department Working Paper, No. 357 (June 2003) and were also published in the *2003 OECD Economic Outlook* No. 73 and used in the *OECD Economic Surveys* of several countries.
6. The amended Law on "Organisation of Insurance Business" No. 204-FZ of 20 November 1999 stipulates that the maximum foreign equity participation in the total charter of insurance companies shall not exceed 25% in the whole economy. Since 1999, foreign owned insurance companies have been allowed to operate in Russia subject to a 49 per cent equity restriction. On 17 January 2004, a law came into force that effectively exempts EU-based insurance companies from this 49 per cent cap.
7. Federal Law No. 17-FZof 3 February 1996 "On Banks and Banking Activities" mentions the principle of a sectoral quota on foreign participation in the Russian banking system. The article of the Resolution of the Central Bank No. 437 of 23 April 1997, which implicitly confirmed a quota of 12 per cent, was cancelled by the Central Bank Directive No. 1204-U of 4 November 2004. In practice, no overall sectoral quota on foreign ownership has been applied, but its implementation remains legally possible.
8. The following legislation is relevant for movement of foreign staff: the federal law "On the Legal Status of Foreign Nationals in the Russian Federation" of 1 November 2002 and the Government Decree No. 335 of 9 June 2003 on "Regulations on a visa form, procedures and conditions of its issuing."
9. The Federal Service of Migrations is reportedly preparing amendments to legislation concerning work permits for foreigners in Russia, which should considerably facilitate the implementation of current regulations, in particular by phasing out the obligation for foreign firms established in Russia to request work permits for foreigners they employ.

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Chapter 2

Russia's Investment Policy Transparency: Views of Foreign Investors

The OECD investor survey was conducted in the first half of 2005 to evaluate Russia's investment policy transparency. More than 100 foreign owned firms operating in Russia responded to a questionnaire based on the OECD Framework for International Investment Policy Transparency and the OECD Checklist of FDI Incentives. In the view of foreign investors, access to information on existing legislation and regulations has improved in many areas (e.g. foreign exchange regulations), but some procedures remain time consuming and costly, in particular land and property registration and work permits. Another criticism concerns the lack of timely information on forthcoming regulatory changes which results from insufficient consultations between the government and the business community. Results of some other business surveys recently conducted in Russia broadly confirm the findings of the OECD survey, indicating in particular that the lack of predictability affect adversely the perception of the investment climate by both potential and established foreign investors.

1. OECD investor survey

The OECD survey of 102 foreign firms present in Russia was conducted in co-operation with the Association of European Businesses in Russia and the OECD Business and Industry Advisory Council (BIAC) in the first half of 2005.[1] The objective of the exercise was to evaluate foreign investors' perception of selected aspects of Russia's investment policy, in particular access to business-relevant information provided by federal and regional administrations, consultation procedures carried out by Russian authorities and administrative capacities at different governmental levels to implement and monitor investment-related measures. The survey thus focused on the key issues of information access and transparency, whereas it has not addressed directly several other critical aspects of the business climate, such as corruption, tax implementation and protections of intellectual property rights, which are perceived as important barriers by foreign investors.

1.1. Information access on federal legislation and regulations has improved but less so at the regional level

The survey shows a certain contrast between, on the one side, a largely critical view from most of the respondents on general efficiency of governmental investment policy and, on the other side, a relatively high level of satisfaction with information accessibility and procedures in a number of specific areas under review. Thus, the majority of companies (64 per cent) evaluated Russian governmental policies to attract and promote foreign direct investment as insufficient or ineffective. In this respect, wholly foreign-owned firms and those engaged in foreign trade activities were most critical. However, when asked to assess the availability of information on licensing, registration, customs and merger and acquisitions regulations, the level of satisfaction varies between 50 and 70 per cent and the responses tend to be similar at federal and regional levels.

Foreign investors remain nevertheless concerned by insufficient information in some other areas, in particular on real estate acquisitions and work permits which appear more difficult to obtain, especially at the regional level. Other problematic areas are information on availability of tax exemptions and on environmental protection requirements, also mainly in the regional context. Information on legal and regulatory changes poses particular difficulties to foreign investors: at the national level, 52 per cent of firms considered it to be a medium to very serious problem as did 65 per cent at the regional level (Table 2.1).

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Table 2.1. **Access to information on government policy and regulatory changes relevant to foreign investors at the national and regional levels**

	Percentage of respondents	
	At the national level	At the regional level
Not a problem or minor problem	48.0	35.4
Medium problem	33.3	36.5
Serious and very serious problem	18.7	28.1
Total	100	100

Source: OECD investor survey, 2005.

There is no clear trend regarding foreign firms' experience with specific investment-related regulations and procedures. For example, half of the firms have no or minor problems with monetary costs of registration and licensing, but consider the delays in these procedures as serious or very serious problems. Opinions on sanitary inspections and administrative controls are divided: the clarity and transparency of the rules and their uniform and impartial implementation are not a problem or only a minor problem for one third of respondents compared to another third of respondents who see these areas as serious or very serious problems. Clarity and transparency of customs rules and implementation procedures represent a medium problem for 43 per cent of respondents and serious to very serious problems to other 30 per cent. The predictability and impartiality of customs procedures seem to pose more problems to foreign firms than do pressures for illegal payments. Regarding appeal and arbitration bodies, foreign firms complain less about the access and transparency of the rules and proceedings but are mainly dissatisfied with a perceived lack of uniformity and impartiality and especially with the insufficient rapidity and effectiveness of arbitration and appeal bodies (considered as serious or very serious problems by more than 42 per cent of respondents).

Among various information sources, the surveyed companies rely mainly on Russian law and consulting firms (60 per cent) and business newspapers (57 per cent). Russian government sources are used by more than 54 per cent of respondents, especially official legal gazettes and official websites provided in English. While primary legislation seems to be relatively widely available in English, secondary legislation – particularly legislation and regulations issued by regional authorities – is usually available only in Russian. The majority of firms rarely have formal or informal contacts with the government and are unfamiliar with the possibility of contacting government enquiry points. The size of companies is an important factor in selecting information sources: small companies are more likely to rely on personal contacts (55 per cent) while large companies (47 per cent) use foreign consulting companies more frequently.

1.2. Problem of insufficient consultations

One of the major complaints of foreign companies is a lack of governmental consultations with foreign business prior to introducing new measures: 73 per cent of the firms find these consultations insufficient, more than 78 per cent consider them insufficiently open to all interested parties and even a larger percentage (79 per cent) think that the accessibility to such consultations is not clearly defined (Table 2.2). However, the majority of foreign investors (59 per cent) find the Foreign Investment Advisory Council (FIAC) effective or sufficient for raising their concerns regarding policies that affect their business. Respondents were generally more sceptical about the similar role of the FDI ombudsman.

Table 2.2. **Consultations between the government and investors on planned laws and regulations**

	Percentage of respondents		
	Sufficient	Insufficient	No reply
Do the Russian authorities consult with investors sufficiently before the introduction of new measures?	24.5	72.5	3.0
Are notification/consultation procedures open to all interested parties, including foreign investors?	19.6	78.4	2.0
Are exceptions to accessibility to notification/consultation procedures clearly defined and delimited?	16.7	79.4	3.9

Source: OECD investor survey, 2005.

1.3. Unclear roles of federal and sub-national authorities in investment policy

Whereas the majority of respondents (65 per cent), especially among Moscow-based firms, considered the role of federal authorities to be well or sufficiently defined, most firms have difficulties in seeing clearly the role of regional and local authorities in managing and implementing investment policies. This view is coherent with another result of the survey, which indicates more negative views of foreign investors on the capacities of lower governmental levels to manage and monitor investment-related policies and incentives. Exact investment policy prerogatives are also of concern in the case of specialised investment agencies: 68 per cent of foreign firms think that their role is insufficiently or totally unclear. When asked to evaluate possible remedies, almost 57 per cent of foreign firms see a one-stop shop as an

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effective means to assist them in getting established and during their operations. Improvement of administrative structure is viewed as the main condition for enhancing governmental investment polices (76 per cent), followed by training of officials, whereas investing in new technologies is considered less important.

Foreign investors considered that the oversight and evaluation of investment policies is conducted in a relatively satisfactory manner by industry associations (almost 56 per cent of respondents) and parliamentary bodies (53 per cent of respondents), but that the general public does not have enough opportunity to discuss and evaluate foreign investment-related policies. Finally, the foreign business community does not see a major problem of consistency of Russian investment policies with the country's international commitments.

The OECD investor survey indicates positive developments in access to and availability of business information in certain previously highly criticised areas such as foreign exchange regulations. Regarding customs procedures, which have often been identified in the past as the major obstacle by foreign and domestic operators, the implementation of the 2004 Customs Code seems to bring significant improvements. A "new customs policy" programme under preparation by the government intends to address in a comprehensive manner remaining problems relating to the opacity and complexity of customs procedures still hindering business activities. Foreign firms also face difficulties in finding readily available information, especially regarding real estate acquisitions or work permits.[2] Wholly or majority foreign-owned businesses and import/export oriented firms remain more critical about transparency and information access. Information sources used by foreign firms are diversified, with information provided by the government playing a relatively important role compared to other sources offered by specialised firms. The main problem remains the timely transmission of information to the business community about regulatory changes introduced by the government. More generally, the existing consultation mechanism for dialogue between business and government is not considered satisfactory.

1.4. Policy implications of the OECD survey's findings

To supplement the OECD survey, the Investment Policy Department of the Ministry of Economic Development and Trade accepted to respond to a series of similar questions to those addressed to foreign investors. This initial investment policy self-evaluation by the government could assist it in identifying the main policy priorities. Understandably, the authorities have generally more positive views on the existing framework and its implementation than foreign firms. In particular, the Russian authorities stress that transparency has been receiving increased attention in government policies including, for example, the new 2004 Urbanisation Code of the Russian Federation, which seeks to improve transparency in territorial planning and construction procedures. Transparency concerns have also motivated the proposed revisions of the Forest and Water Codex.

The government also prepared a new law on information disclosure with the aim of clarifying the rights of the public to access information and the obligations of the authorities to provide it. The government's draft proposal stipulates that, except for confidential information and state secrets, the authorities should publish all documents, orders and application rules and provide them on their website free of charge (or charge only the price of a paper copy). If the officials do not promptly provide requested information, they would be liable to high penalties and even dismissal under the amended Administrative Code. The government's proposal would be an important contribution to enhancing general transparency and it is therefore essential to speed up the legislative process in the Duma and ensure that the law enters rapidly into force.

According to the government, information on most areas under review is readily available, especially at the federal level, though some problems persist at the regional level regarding the availability of information for example on tax exemptions and work permits. In its evaluation of information sources, the Russian government thinks that foreign investors rely mainly on foreign consulting firms, business associations and personal contacts, rather than using Russian governmental sources. Among information sources provided by the Russian government, the federal authorities and foreign investors agree on the high relevance of official legal gazettes. However, the authorities consider the governmental website in Russian as the most frequently used information source, whereas foreign investors prefer to consult their English version. The infrequent use of governmental special enquiry points is also confirmed by the authorities. Improving the administrative structure is considered by both the government and foreign investors as the first priority to enhance investment policy implementation, followed by the need for training officials and investing in new technologies.

Regarding foreign investment-related policy, the government emphases that its key principle is to guarantee national treatment to foreign investors and therefore at the federal level, the main instruments are limited to policy support aimed at reducing political and financial risks. At the regional level, the incentives consist not only of tax exemptions but other mechanisms are also used, including providing guarantees and regional investment promotion activities. In general, the government considers current investment incentives sufficient for stimulating foreign investment to Russia in general and within the regions, but less efficient in attracting foreign investment to specific sectors.

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The comparison of the findings of the investor survey and the government's self-evaluation identifies several investment policy priorities. First, the government should adopt a more pro-active approach in making business-related information available and using electronic media more extensively to publish existing regulations, especially in other languages, given that the majority of foreign investors rarely use the government's websites and declare that they would prefer to consult an English version.

The government should take into consideration foreign investors' difficulties to clearly identify the delimitation of different levels of the Russian administration in designing and implementing investment policies and incentives**.** Another task for the government is to respond to the strong concerns of foreign investors regarding limited access to and insufficiency of consultation procedures on regulatory changes and on planned new laws and regulations.

It is important to emphasise that the OECD investor survey questionnaire was based on the OECD Framework for International Investment Policy Transparency and therefore focused on information access and transparency issues. As a result, some other important aspects such as corruption, tax implementation and protection of intellectual property rights were not addressed directly in the survey. It remains, however, that these problems are cited by foreign investors as important impediments to their establishment and operations in Russia and should therefore remain key policy priorities for the government.

2. Russia's business environment in light of other recent business surveys

The OECD investor survey was not intended to directly address all aspects of the investment environment. Several recent business surveys provide further interesting insights on implementation issues, in particular the 2005 FIAC survey on "Russia: Investment Destination", the World Bank "Doing Business" database, the 2005 World Bank/EBRD Business Environment and Enterprise Performance Survey and the survey of Japanese enterprises.

According to the **FIAC survey** conducted at the beginning of 2005, the main impediment to foreign investment in Russia is corruption, followed by administrative barriers and the selective interpretation and application of laws. It also shows that potential investors meet more difficulties in obtaining credible information to make their investment decisions than firms already present in Russia. In addition, investors and potential investors think that investment in Russia would increase if the government were to communicate better. These views confirm the findings of the OECD investor survey on the need for the government to continue to enhance transparency and access of foreign investors to business information and further develop consultations with the business community to ensure that new and planned laws and regulations do not have a negative impact on the investment climate.

The third round of the **World Bank/EBRD Business Environment and Enterprise Performance Survey** conducted in 2005[3] provides comparisons of all Eastern European countries and the CIS for a number of important aspects determining the business environment, including business regulations, labour and taxation issues, as well as access to infrastructure and finance, as perceived by the firms operating in these countries. Compared to 2002, in 2005 Russian firms reported improvements in customs and trade-related regulations, tax administration and, to a lesser extent, business licensing and permits, but a deterioration in labour regulations and corruption. The most worrying trend shown by the survey remains firms' perception of further increase in corruption pressures in Russia. Among the three indicators of corruption analysed, only the so-called "bribe tax" (unofficial payments to public officials as a percentage of annual sales) diminished in Russia between 2002 and 2005, whereas the two remaining aspects have increased: the "frequency of bribery" (*i.e.* the percentage of respondents admitting to pay frequently or usually irregular payments for activities related to customs, taxes and licences) and, especially, the "kickback tax" (*i.e.* the percentage of contract value that is paid in additional or unofficial payments to secure government contracts).

The **World Bank** "**Doing Business**" database[4] offers a regularly updated snapshot of the business climate in a large number of developed and developing countries. The last available data for 2004 indicate that, compared to other countries, Russian regulations for hiring and dismissing workers and closing a business are relatively business-friendly, but its situation in other analysed indicators is less favourable. For example, starting a business requires on average 36 days and 9 different procedures in Russia, compared to 25 days in OECD countries. Confirming the findings of the OECD investor survey, the WB database also shows the difficulties experienced by firms to register property: there are 6 different procedures necessary to transfer property from the seller to the buyer which take 37 days in Russia (as opposed to the OECD average of 4 procedures and 34 days). However, the cost of property registration procedures is lower in Russia than in more developed countries.

The **FIAS 2004 survey of Russia Runaway Investors**[5] was addressed to "non-investors" who either cancelled investment projects in their initial stage or abandoned them shortly after their initiation or after a certain period of operation. It also confirms that land access and related registration procedures are viewed as the major dissuasive element in business decisions in Russia, especially among foreign investors. The fact that runaway investors mentioned work permits for expatriates as one of the most serious difficulties within start-up procedures also reinforces the similar point made in the OECD investor survey.

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The **Russian-Japanese Committee for Economic Co-operation** conducted in 2004 and 2005 the surveys on Russia's business climate among the members of the Japan Business Federation (Nippon Keidanren).[6] The survey brings additional arguments to the conclusions of the OECD investor survey, in particular the need for Russia's government to improve access to information and the transparency of its investment policy *vis-à-vis* potential foreign investors. More than 90 per cent of Japanese investors already operating in Russia evaluate positively or very positively the business perspective in Russia, but only 37 per cent of Japanese firms not present in Russia share this opinion. According to Japanese firms, the most urgent areas to be improved are the simplification of visa and work permit procedures and greater transparency of existing procedures, including at the regional level.

3. Private-public consultations in Russia

Difficulties in informing market participants in a timely manner about new and/or forthcoming legal and regulatory changes partly stem from the very nature of the unfinished transition process, which requires frequent adjustments. A certain degree of regulatory instability is thus inevitable and generally well understood by market participants. However, in such conditions the government should intensify its efforts to develop adequate mechanisms to consult the business community and inform market participants sufficiently in advance about newly introduced measures. Regulatory transparency and predictability are particularly important for small domestic investors and for foreign investors, especially potential ones as they are by definition less familiar with national legal and regulatory environment than incumbent firms. In principle, Russia has a relatively well structured network of business associations, which seek to represent the interests of their members to the federal or regional authorities (see Box 2.1).

The OECD investor survey focussed on the two main existing structures for a dialogue with foreign investors in Russia: the Foreign Investment Advisory Council (FIAC) and the FDI ombudsman. The respondents viewed the FIAC as more efficient than the FDI ombudsman and this opinion is also shared by the government. However, the FIAC seems to remain mainly a forum for large established investors and is probably less responsive to the needs and problems of new investors and small and medium-sized enterprises. The FDI ombudsman is known mainly to the FIAC members and its action restrained since administrative capacities available in the State Apparatus to deal specifically with investors' complaints are limited. Moreover, the interventions of the FDI ombudsman address usually the problems faced by foreign investors in their interaction with the federal government whereas – as also confirmed by the OECD survey – most difficulties appear in the regional context. In this respect, the existing network of regional Chambers of Commerce and Industry could

Box 2.1. **Main existing structures for private-public dialogue in Russia**

A) Domestic business associations

The Chambers of Commerce and Industry (TPP in Russian): the largest business association in Russia, representing some 20 000 enterprises in 169 regional Chambers; it includes 178 business associations and has offices in 14 countries. It provides assistance to its members in establishing contacts with foreign firms and representing them especially in relations with regional authorities.

The Russian Union of Industrialists and Entrepreneurs (RSPP in Russian): created in 1990, it gathers together mainly directors of large enterprises; since 1994, it has developed a network of 30 industry associations and other affiliated associations in 56 Russian regions.

Business Russia (Delovaya Rossia): initially this grouping organised joint events with the political party United Russia and has developed close links with the government and the President; it does not have regional branches and does not seem provide specific services to its members.

Union of Entrepreneurial Organisations (Ob'edienie Predprinimatelskih Organizatsiy Rossii OPORA): created in 2000, it represents mainly small business associations and individual firms and seeks to defend their interests in relation with regional and local authorities.

Coordination Union of Associations of Employers of Russia (KSORR in Russian): an umbrella organisation; both the Chambers of Commerce and the Russian Union of Industrialists are members. It also represents the business community in trilateral dialogue with government and trade unions.

B) Foreign Business Associations

Foreign Business Associations, e.g. American Chamber of Commerce, German Economic Chamber, Association of European Businesses: these provide various business related information to their members, facilitate networking among foreign firms operating in Russia and present specific issues/concerns related to the business climate to the Russian authorities.

The Foreign Investment Advisory Council (FIAC): established in 1994; chaired by the Russian Prime Minister and coordinated by the Ministry of Economic Development and Trade (MEDT); includes senior managers from 25 major foreign investors in Russia, including British Petroleum, Mobil, Shell, Deutsche Bank, Citibank, Coca Cola, Nestle, Renault, Siemens and Unilever. Between the annual sessions, several working groups that co operate with relevant ministries meet regularly, focusing in particular on state regulations, tax and accounting, financial institutions and capital markets, industry, natural resources and food and agriculture. Currently, the major preoccupation of the FIAC is the planned legislation on strategic sectors.

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Box 2.1. **Main existing structures for private-public dialogue in Russia** *(cont.)*

FDI ombudsman: the function created in 2002 at the request of FIAC; the ombudsman presents its report regularly to FIAC. Traditionally, the function is performed by the Head of Government Apparatus (Mr. Igor Shuvalov until 2004, currently Mr. Sergey Naryshkin). He defends the interests both of foreign and domestic investors and transmits their grievances to relevant parts of the government. Most complaints are resolved directly through internal procedures in co-operation with responsible federal ministries or agencies.

be used more extensively and efficiently in establishing regular contacts between the business community and regional and local authorities and helping resolve practical problems.

The public-private dialogue in Russia has been affected by increasing state economic interventions and uncertainties concerning property rights. The business community has also become more fragmented as the sectors and firms are now able to compete for specific state subsidies provided by the federal or regional authorities. A dialogue between the government and the business community, including foreign investors, requires restoring the mutual confidence, in particular by delimiting clearly the scope and modalities of the state interventions into the economic activities. Different business associations should develop their internal communication and working methods to be able to transmit in a timely and effective manner the concerns and propositions of their members to relevant authorities.

Notes

1. The complete results of the survey are presented in the OECD document DAF/INV/WD(2005)14/ADD1.
2. In recognition of serious shortcomings in Russia's real property market and their negative impact on overall business development, the World Bank launched in July 2005 a Cadastre Development project to help Russia to improve information flows and rationalise procedures of the State Cadastre Agency. See *http://web.worldbank.org*. As regards work permits, amendments to present legislation on work permits of foreigners, currently prepared by the Federal Migration Service, should allow foreign firms established in Russia not to be obliged to request work permits for foreign employees they wish to hire.
3. The EBRD/World Bank Business Environment and Enterprise Performance Survey was carried out in the transition countries for the first time in 1999, then again in 2002 and most recently in 2005. In Russia, 600 firms participated in the third

round of the Survey. The main results of the survey are analysed in EBRD *Transition Report 2005: Business in Transition*, London, November 2005.

4. See *www.doingbusiness.org.*

5. Collidge J., Kisunko G., Steinbuks: *Russia Runaway Investors*, Foreign Investment Advisory Service, A Joint Service of the International Finance Corporation and the World Bank, June 2004.

6. 127 firms participated in the 2004 survey and 181 firms in 2005, including enterprises not established in Russia and those already operating in the country.

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ANNEX 2.A1

OECD Investor Survey

Sample of the respondents

One hundred and two foreign firms which responded to the OECD questionnaire cover a broad spectrum of business activities, market orientation, ownership structure, company size and location. The sectoral breakdown of the sample is relatively representative of the overall FDI structure in Russia as trade and repair activities are the largest category (20 per cent) and financial services (16 per cent) and manufacturing (14 per cent) are also covered. Most responding firms are wholly foreign-owned (73 per cent) and have generally a single operation in Russia. Similarly to the general geographical distribution of foreign investment in Russia, a large part of surveyed firms (44 per cent) operate in Moscow and the surrounding region. Production of the majority of surveyed companies is primarily for the Russian market, and almost 50 per cent of the firms import more than half of their input. From the point of view of the company size, the sample is more or less equally distributed among small firms with less than 50 employees (39 per cent of the total), the firms with more than 500 persons (32 per cent) and those with 50 to 500 employees (29 per cent).

Figure 2.A1.1. **Sectoral structure of respondent firms**

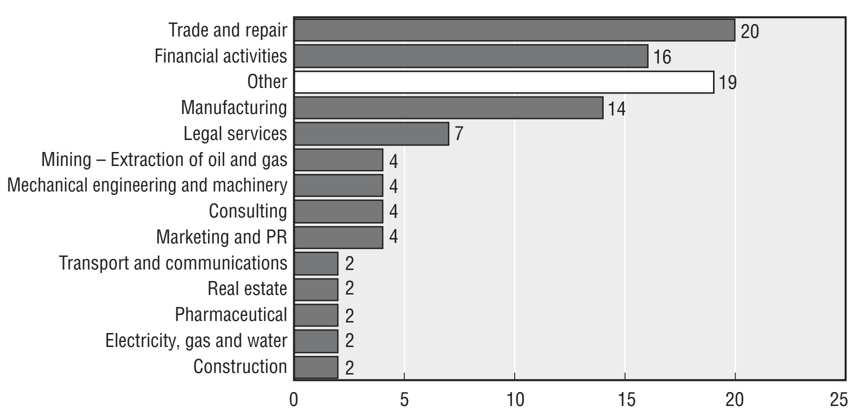


Figure 2.A1.2. **Ownership structure and number of operations**

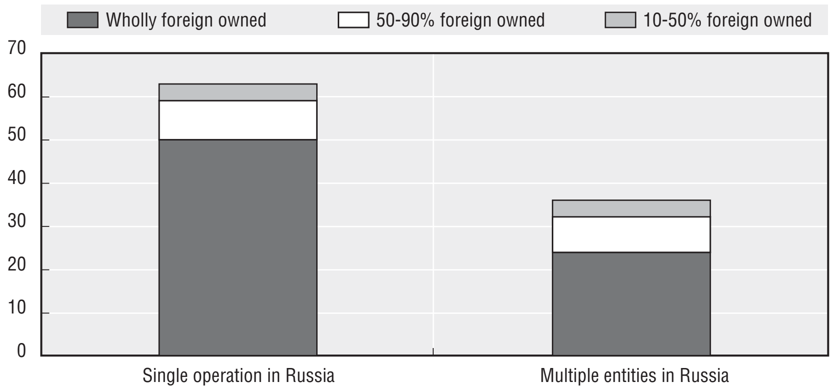


Figure 2.A1.3. **Location of respondent firms**

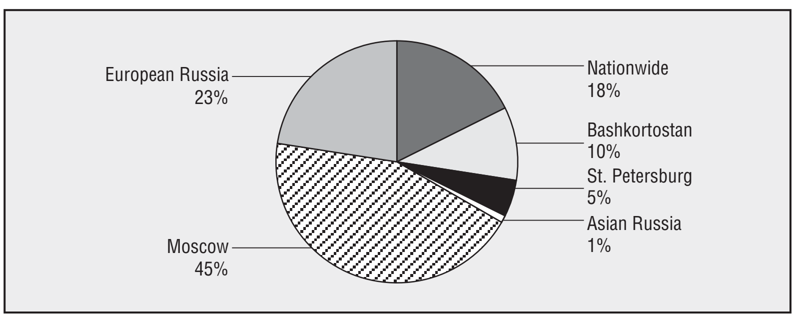
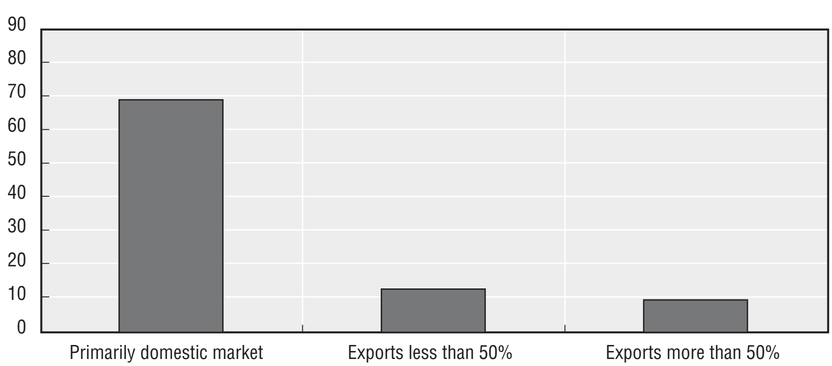


Figure 2.A1.4. **Market orientation**



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Possible limitations of the OECD survey

As with any business survey, the results of the OECD survey should be interpreted with caution due to general and also specific problems encountered in Russia. To obtain a high response rate and save time of senior managers to whom the questionnaire was addressed, the survey was presented in the form of multiple-choice questions with optional further comments. It was possible to conduct only a limited number of personal interviews with firms' representatives. Despite the efforts to adapt the OECD language primarily oriented to governmental circles, some questions may not appear to be directly relevant for business.

Another possible shortcoming is that the survey does not cover potential investors and/or foreign firms, which have decided not to enter or have decided to leave Russia. All respondents are foreign investors already operating in Russia, familiar with this environment and therefore possibly inclined to either underestimate current obstacles or, conversely, dramatise the situation to discourage eventual competitors. Some foreign firms with strong links to local authorities might hesitate to be very critical. In the OECD survey, this is probably the case of 10 replies from Bashkortostan received via regional authorities, which assessed the investment environment significantly more favourably than other respondents.

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Chapter 3

Investment Policy Implementation: A Regional Dimension

Attracting foreign investment to regions other than large cities and to sectors other than energy, which have been so far its main beneficiaries, is one of the important goals of Russia's economic policy. Despite a number of comparative advantages many Russian regions can offer, such as relatively cheap land and property and qualified workforce, their investment environment is still perceived as being insufficiently attractive by foreign investors. The efforts of the regions to tackle investment barriers, in particular by granting tax incentives and developing investment promotion programmes, have not brought so far expected results. The objective of the recently adopted laws on Special Economic Zones (SEZ) and "Concessions" to make specific regions and sectors also attractive to foreign investors could be attained only if they are implemented in a non-discriminatory and transparent manner with a minimum of market distorsions.

1. Unclear delimitation of responsibilities at different levels of government is an impediment to investment

Foreign direct investment remains highly concentrated in a few Russian regions. These regions either offer an easy access to large local markets (Central and North-West Federal Districts) or benefit from important natural endowments (*e.g.* Ural and Far Eastern Federal Districts) (Table 3.1). At the same time, most Russian regions (50 out of the total of 64) each attracted in 1995-2003 only USD 0.3 billion in cumulative foreign direct investment inflows.[1] Rising costs of land and property in large cities and emerging shortages of qualified labour in these areas now offer a real opportunity to other regions to compete for foreign direct investment.

Table 3.1. **Foreign investment in Russian Federal Districts**

USD million

	2002	2003	2004	Jan.-Sept. 2005
Central Federal District	9 526	15 664	19 277	2 357
North West Federal District	1 594	1 877	2 869	13 734
Southern Federal District	587	666	689	696
Volga Federal District	1 449	945	2 415	1 101
Ural Federal District	2 539	5 562	7 033	1 730
Siberian Federal District	2 944	2 138	3 154	2 677
Far Eastern Federal District	1 141	2 847	5 073	4 530
Russian Federation as a whole	19 780	29 699	40 509	26 825

Source: Federal State Statistical Service.

In addition to some frequently evoked drawbacks which are common to many regions in other countries, such as less developed infrastructure, greater distance from policy decision centres and financial facilities, Russian regions suffer from several additional impediments to foreign investment. Most foreign investors find it more difficult to access to business relevant information in regions as compared to large cities and have problems in dealing with regional authorities especially with respect to registration procedures and taxation issues. The OECD survey also confirmed that for foreign investors the role and prerogatives of regional *versus* central authorities in various investment-related matters are not clearly delimited.

The Russian Constitution delineates the boundaries between jurisdictions and powers of the Federation and its Subjects and defines the areas of their joint competence (Box 3.1). In practice, however, these relations have not been straightforward and have evolved considerably in the last fifteen years. In the 1990s, strong decentralisation pressures by the regions further accentuated regional heterogeneity and market fragmentation inherited from the Soviet past. Starting in 2000, the federal government undertook vigorous re-centralisation campaign, pursued at the political level (the creation of seven federal districts headed by the presidential representatives) as well as on the legal and economic fronts. An extensive revision of regional laws resulted in the abolition of a number of regional legal acts considered contrary to federal

Box 3.1. **Responsibilities of federal and regional authorities in the Russian Federation**

Russia comprises 88 regions ("Subjects of the Federation") that include 21 ethnic republics, 48 oblasts (or provinces), 7 kraïs (or territories), 9 autonomous okrugs (districts), one autonomous oblast and the two federal cities of Moscow and St. Petersburg. The delineation of jurisdictions and powers between the Federation and its Subjects is stipulated in the Articles 71, 72 and 73 of the Constitution of the Russian Federation, which define that:

i) The sphere of exclusive competence of the Federation includes the legal foundation of the single market, regulations of financial, currency and customs matters, foreign policy and international treaties and foreign economic relations (Article 71).

ii) Joint jurisdiction of the Federation and its Subjects covers the issues of the ownership and use of land, mineral resources, water, delimitation of state property, environmental protection, public health and taxation (Article 72). The joint jurisdiction also concerns "co-ordination of international and foreign economic relations of components of the Russian Federation and the fulfilment of the Russian Federation's international treaties".

Following the entry into force of the Law "On the Principles and Order of Division between the Administrative Bodies of the Federal Centre and Subjects of the Federation"(of 24 June 1999), new regional legislative acts must be discussed and passed to the Federation Council for final approval. President Putin used his right set up by Article 85.2 of the Constitution to suspend regional legislation found to be in contradiction with federal legislation. In April 2001, it was announced that four fifths of regional legislation had been brought into compliance with federal norms, including the legislation concerning transport, migration, trade and licensing.

legislation. The overhauling of the tax system has reduced the discretion of the regions over economic policy in general and tax matters in particular.[2]

Strengthening of the federal authorities' economic policy power has not, however, prevented the regions from exerting significant influence on the local economic and legal environment and implementing measures that express local rather than federal policy orientations and can lead to "regional protectionism". This relative independence of the regions *vis-à-vis* the centre is possible mainly because sub-national authorities have considerable control over regional branches of federal institutions as their staffs are appointed and often paid by the regions. Regional branches are responsible for the design and implementation of a number of important regulations in the regions, including taxation procedures, land registration and sanitary and environmental regulations.

2. Limited impact of regional tax incentives

In Russia, no tax incentives have traditionally been available at the federal level (though the new Law on Special Economic Zones seems to change this – see below). Conversely, tax incentives are the main instrument used by the regions to attract foreign investors. These tax exemptions concern the parts of federal taxes, which are under the control of the regions and/or the taxes collected and retained by the regions. Concretely, the regions frequently offer foreign investors a reduction in the regional element of the federal income (profit) tax rate from the normal rate of 17.5 per cent to 13.5 per cent. They have discretion to grant exemptions on corporate property tax, transport and land taxes, which are under the exclusive control of regional and local budgets (see Table 3.2).

Regional tax incentives are granted to so-called "priority" or "high priority" investment projects. The definition and the selection of these projects vary greatly amongst the regions. The most frequently used criterion is the amount of foreign investment. For example, in the Republic of Bashkortostan, foreign participation in a priority project must be at least RUR 350 million. The status of a (high) priority project may be linked to a specific type of activity, for example the extraction and processing of mineral resources, or to high technology content. The current system thus gives considerable discretion to regional and local authorities to select priority projects and adjust the tax rates accordingly. Based on negotiations, the process usually favours incumbent firms or enterprises with strong negotiating power at the expense of outsiders and smaller enterprises.

When considering the expected tax burden, investors take into account not only statutory tax levels and provisions, but also tax compliance costs, including complexity, transparency and predictability of tax procedures. Several recent business surveys confirm that tax compliance costs represent a

Table 3.2. **Main taxes and possible tax reductions in the Russian Federation**

Taxes/Tax base (TB)	Tax rate	Federal budget	Regional budget	Local budget	Comments
Income (profit) tax TB: firms' financial results	24% (can be lowered to 20%)	6.5%	17.5% (can be lowered to 13.5%)		Frequent reduction on the regional tax component, *e.g.* for high priority projects (Republic of Bashkortostan, Astrakhan region); for specific sectors (agriculture in Kaluga region). Full exemption for residents of Kaliningrad SEZ.
Value-added tax TB: sales of goods and services	18% 10% for foodstuffs and children products 0% on exports	All			
Unified social tax TB: payments to employee	26%	All			The rate reduced to 14% in technical and innovation SEZ.
Individual income tax TB: aggregate personal income	13% for residents 30% for non-residents	All			
Corporate property tax TB: fixed assets	0.9-2.2%		All		Possible reduction up to 50-90% for priority investment projects (*e.g.* Astrakhan) exemption for 5 years (*e.g.* Republic of Bashkortostan)
Transport tax TB: motor capacity	Depending on type and capacity		All		Possible reduction up to 50-90% for priority projects
Land tax TB: land plots	0.3%: agricultural land, housing, municipal infrastructure 1.5%: other land			All	Tax reduction possible for priority projects. Exemption for SEZ residents in the first 5 years of their operations.
Individual property tax TB: real estate of natural persons		0.1-1% according to value of property		All	

significant problem for foreign investors in Russia. Both at the national level and within the regions, the best way to improve general transparency and predictability and reduce the risk of corruption is general simplification of the legal and regulatory framework to make it less vulnerable to selective interpretation.

Aware of the highly dissuasive effect of several tax-related cases on new foreign investment, the government seeks to curb and better control the prerogatives of tax authorities. In particular, the new law currently examined by the Duma intends to clearly specify the rights and obligations of both of tax payers and tax authorities, including for example the regulations in the case of prolongation of tax control and regarding the list of documents to be submitted by firms during such procedures. Some interesting initiatives aimed at reducing other administrative barriers have been undertaken in several regions. For instance in the region of Archangelsk, a specific commission was established with the objective of making proposals for removing administrative barriers that impede business in the region, especially with respect to licensing, certification and registration procedures. The Republic of Karelia in the North-West Region in 2004 created a working group headed by the Prime Minister of the Republic to review regularly the implementation of ongoing projects and assist investors in resolving problems for which regional executive authorities may be responsible.

3. Initiatives to improve information access, consultations and investment promotion

The recently decided establishment of a register of regional and municipal legislation will be an important step in improving the access to information on regional laws and regulations. Maintained in parallel with the already existing Federal Register containing federal legal acts, the new Register will cover regional and municipal legislative acts concerning in particular local taxes, land registration and communal services.

In addition to specific incentives and attempts at reducing administrative barriers, the Russian regions devote considerable financial and human capacities to investment promotion activities. Several regional examples of such activities indicate, however, that responsibilities of different governmental units and special agencies responsible for investment promotion are often unclear and their multiplication casts doubts on their cost efficiency.[3]

It could be questioned whether relatively small regions such as Astrakhan with limited budget and staff capacities need a fully fledged specialised investment promotion agency. In most cases, the main role of regional investment promotion agency seems to be "marketing the region", *e.g.* organising travels abroad, press invitations, international seminars and publishing brochures, which are usually costly and not necessarily very efficient. Thanks to e-publishing, this function could quickly be ensured with considerably less funds, for example through a good investment promotion website. In this context, the recent experience of some small countries in merging investment with export and even tourism promotion could be worth considering.

The three regional studies carried out for the 2006 OECD Review (Astrakhan region, Bashkortostan republic and the North-west region) showed that regional tax preferential schemes and resource-intensive investment promotion programmes have not brought expected results in terms of increased foreign investment flows. This does not mean, however, that the regions have no means of encouraging and promoting investment but rather that they should shift their policy priority towards other areas, in particular improve information access, streamlining administrative procedures within the regions and offering linkage programmes involving the local business community.

The federal government also envisages improving and streamlining its investment promotion activities. A special unit, recently created within the Investment Policy Department of the Ministry of Economic Development and Trade, was assigned a task to develop a new concept of investment promotion with a special focus on reducing administrative barriers to foreign investment.

4. Opportunities and challenges of the new law on SEZ

4.1. Main provisions of the SEZ law

The Federal Law No. 117 "On special economic zones in the Russian Federation" adopted on 22 June 2005 is a central piece in the government's programme of economic diversification and modernisation aimed at overcoming the country's heavy dependence on energy and raw material production and exports. It also intends to contribute to the development of economically depressed regions. According to the new Law, two categories of SEZ[4] can be established on land owned by federal or local governments for a maximum period of 20 years.[5]

i) An industrial production SEZ can be created on a territory of up to 20 km^2. The value of each project should be at least € 10 million (€ 1million in the first year) and in the form of greenfield investment in the activities other than mining and processing of natural resources and processing of ferrous and non-ferrous metallurgy products.

ii) A technology-innovative zone can be established on a territory up to 2 km^2; there is no minimum investment limit for such a project.

SEZ resident firms whether national or foreign-controlled are eligible for various tax incentives, in particular exemptions on regional taxes (property and land taxes), but also and, in contrast to previous practice, the federal government will offer reductions on the federal unified social tax to firms in technology-innovative zones from the normal 26 per cent rate to 14 per cent (see Table 3.2). Industrial firms will be able to accelerate depreciation of their fixed capital investment, transfer their losses to following years and include their R&D spending in current expenditures. Registration procedures for SEZ-based firms are to be simplified, in particular thanks to the "one-window" arrangement and the number of tax inspections is to be reduced. SEZ-based firms will benefit from a number of customs privileges, in particular exemption of customs duties and VAT on their imports and exemptions of excise duties on Russian goods. Exports of goods from SEZ will not be subject to payments of customs duties, VAT and excise taxes.

The oversight of the SEZ programme is carried out by a newly created Federal Agency for Managing SEZ under the supervision of the Ministry of Economic Development and Trade. A special committee, in which different ministries are represented, is responsible for estimating and selecting the requests for creation of SEZ. Each SEZ will be managed by a supervisory board, which will also include representatives of SEZ-based firms. Financing of transport and other infrastructures will be partly financed by the federal budget (between 50 to 75 per cent according to different zones) and the remaining cost by regional budgets. The Federal SEZ Agency also negotiates with Russian banks the possibility of guarantees and privileged credit conditions for SEZ-based firms.

In November 2005, the results of the first round of tenders were announced. Among 70 candidates, 6 regions were selected: four sites for technology-innovative zones (Zelenograd, Dubna, St. Petersburg and Tomsk) and two sites for industrial production SEZs (the Lipetsk Region and Elabuga in Tatarstan).[6] These SEZs are expected to be operational in 2007. Several large OECD-based groups reportedly expressed their interest in establishing enterprises in the new SEZs, including Siemens, Boeing and Cisco. Several other technology-innovative zones are planned, in particular in Novosibirsk, Tyumen, Kazan and Sarov (in the Nijni Novgorod Region).

According to preliminary estimates of the Ministry of Economic Development and Trade, a SEZ is expected to produce an annual output of USD 210 million, create some 14 000 jobs and attract foreign investment of USD 330 million. Annual budget revenues from one SEZ are expected to amount to USD 36mn.[7] However, it does not seem that an overall assessment of costs and benefits of SEZ has been made by the authorities.

4.2. Minimising distortions

It is premature to judge at this early stage the possible impact of the new SEZ legislation, but several questions of a general nature and more specifically regarding its implementation can be raised. In general terms, creating specific

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conditions for particular sectors and enterprises entails risks of distorting market conditions and weakening competition, thus having adverse effects on a country's overall economic development. Similar to international experiences with SEZ or export processing zones (EPZ) schemes, Russia's recent experience with SEZ in particular in Kaliningrad has been mixed. Such zones have tended to create enclaves rather than become the engine of general economic development. For instance, in 1999 Ukraine introduced special (free) economic zones, each of them offering specific *ad hoc* tax and customs privileges to investors. According to the World Bank, the system has proved to be costly in terms of lost tax revenues, increased economic distortions and vulnerability to abuse and tax evasion. The government recently introduced a moratorium on the creation of new zones and envisages bringing tax privileges in line with best international practices.[8]

It will remain to be seen to what extent favourable tax conditions offered in Russia's SEZ will represent sufficient incentives for domestic and foreign firms to compensate a perceived lack of predictability and other investment risks. In general, the low tax rates have often been secondary and the main "selling point" of SEZ in most countries has been that such zones offer a greater flexibility and lower risk than the general economy where investors can be subject to predatory tax inspections and costly and time-consuming administrative procedures.

Furthermore, the respective roles of the regions and the new Federal Agency for Managing SEZs in financing and managing these territories are not clear. In many countries the management of SEZs is implemented by specialised companies experienced in real estate and service management. Another potentially controversial aspect of the new Federal Law is that the disputes concerning the establishment and functioning of a SEZ are to be settled in court according to the legislation of the Russian Federation, which means that parties are not allowed to seek settlement of disputes by international arbitration.

The Russian authorities seem to be aware of these different risks often associated with the creation of SEZ. The SEZ scheme is thus considered as a pilot project to be carefully evaluated in a few years. Given that the main objective of the SEZ is to reduce administrative barriers, the authorities expect SEZ to be particularly attractive to foreign investors which often see the impediments in this area as the main obstacle to their establishment and operations in Russia. A relatively high threshold for the SEZ projects (€ 10 million in total, € 1 million in the first year) indicates that the participation of SME is not the primary objective of the SEZ as the promotion of SME activities is ensured through other specific programmes.

5. The new concessions law as the first step in developing public-private partnership

The Federal Law "On concessions"[9] is the first attempt in Russia to develop a public-private partnership (PPP) scheme and as such it represents an important step in clarifying the government's long-term strategy on the level and modalities of its economic interventions in different sectors. The objective of the law is to reduce the role of government as direct investor in infrastructure activities that the government does not intend to privatise, in particular highways, pipelines, power plants and grids, airports, railways as well as cultural and medical undertakings.

The main direction of the law is the well-known adage that "when competition is not possible *in* the market, the government must make enterprise compete *for* market". The law defines the conditions and procedures for tenders on the basis of which firms will be selected to manage and invest in infrastructure projects. Concessions are to be granted for a maximum of 99 years. The government is preparing a draft standard concession agreement which will be a basis for future concession contracts. It is also establishing methodological guidelines for concession agreements in specific sectors. Discussions are under way in the government on the possibility of allocating financing from the investment fund, for example to draft feasibility studies for concession projects.

The underdevelopment of Russian infrastructure and many public services may justify PPP as a means of mobilising private financing for their modernisation and injecting the private sector's efficiency to their management. However, the experience of many countries, including among transition economies, shows that these programmes need to be carefully designed. A major stumbling block in the past has been the quality of general investment environment. In general, even the best-designed PPP project is unlikely succeed in an environment where agreements cannot be adequately enforced. Another concern has been the long-term fiscal implications, as many governments have used PPP as a shortcut to off-balance sheet financing of infrastructure and in the process incurred sizeable contingent liabilities. The success of these programmes thus depends on the ability of the government to identify suitable projects, ensure competitive bidding procedures and establish an adequate regulatory and institutional framework.

The objectives of PPP need to be impressed on all levels of government and within all major branches of administration. Also, the responsible public agencies need to have the expertise and capacity to partner actively with private sector infrastructure experts. In this context, although the new law seeks to provide an integrated framework for private investment in the utilities sector, its application will be complicated by the fact that the reforms in a number of closely related areas such as registration of municipal property and tariff regulations are not yet completed. In particular, persistence of subsidised tariffs for most utilities and complex repartition of responsibilities for different sectoral tariffs between regional and municipal authorities will make difficult for the concessionaire to have a guarantee that tariffs received will cover its operational costs. The possibility to renegotiate tariffs, foreseen by the law, could be necessary for the viability of the projects but represents potentially an additional source of uncertainty for investors. In its present form, the law does not allow the concessionaire to use either the concession object or future revenues as collaterals and does not clearly specify the respective obligations of the concessionaire and the concedent for maintenance work related to operations and replacement work.

Foreign investors generally welcome the prospects of private investment participation in infrastructure development and the absence of formal discrimination between domestic and foreign investors. The conditions must be, however, attractive for investors and provide a transparent and stable investment regime. It seems that requirements for the initial bid documentation are very comprehensive and can have the effect of restricting access to some bidders or advantaging others. Also, the guarantees against possible legislative changes, including privatisation of the concession project or land, could be viewed insufficient by many investors given considerable initial costs and possibly prolonged period before incomes are generated.

A final question relates to next steps by the government. As already mentioned, many infrastructure projects rely on public subsidies for their financial viability. To avoid wasteful or illicit practices, a strong legal framework for subsidisation of enterprises is therefore needed. Also, PPPs include, in addition to concessions, instruments with a more limited risk transfer to the private partners, such as delegated management and affermage contract. In some sectors, such as water and sewerage, these have become the preferred option in many countries. Relevant legislation and regulations may still need to be worked out, including at the sub-national levels.

The Russian authorities see the PPP scheme as a means to inject competition especially into the sectors presently dominated by natural monopolies. They recognise nevertheless that the current price/tariff system in many sectors targeted by PPP is not attractive to potential private partners though some specific segments have already raised interest of especially foreign firms, for example building of a toll-road in the St. Petersburg area.

6. The new laws as a part of regional development strategy

Both laws on SEZ and Concessions illustrate a growing importance given by the authorities to regional development and indicate some reorientation in regional policies. The Regional Development Ministry, created in September 2005, has developed a new "Strategy for the Socio-Economic Development of Regions of the Russian Federation".[10] In proposing to allocate central budgetary funds to the so-called "pilot" regions, the programme seems to promote a differentiated or cluster approach to regional development. The selection criteria for pilot regions are not yet clearly established though it seems that raw-material regions are not included. In addition, the government established a new Investment Fund, which will have at its disposal USD 2.5 billion in 2006 and at least the same amount in the two following years. These funds are to be used for developing infrastructures, innovation systems and institutional reforms and distributed in the form of government guarantees and co-financing of specific projects.

In more general terms, the new strategy appears to give a greater role to decentralised initiatives by expanding regional responsibilities and encouraging more flexibility, including in labour markets. The new laws on SEZ and Concessions do not contain an explicit discrimination against foreign investment and participation of foreign investors seems to be even encouraged. However, it remains to be seen to what extent foreign investors will find the conditions offered by SEZ and concession agreements attractive and be ready to be involved in specific projects. There is also concern that these programmes are intended as a tool of the government's new industrial policy of directing investment to certain sectors. A regulatory impact study of these programmes would clarify whether they are indeed lowering administrative barriers and other obstacles to investment.

7. Other recent regulatory developments

A number of other recent initiatives can have a positive impact on the business environment in Russia. In particular, the government introduced several important tax amendments applied starting 2006, which aim at stimulating general investment activity but also respond to the demands by foreign investors. In particular, firms are now allowed to depreciate in a single instalment up to 10 per cent of the value of new fixed assets. VAT reimbursement on capital investment, which intervened previously only after the completion of the whole project, will be accelerated and intervene after a specific capital expenditure occurs. Also in the response to frequent complaints by domestic and foreign operators, the government submitted a law proposal to reduce the power of tax auditors. The amendment of the Tax Code by the Supreme Arbitration Court has a similar motivation as it restricts the time period during which debtors' funds or property could be confiscated by the tax authorities to cover their tax obligations.

Following President Putin's plea in his annual address to the Parliament in April 2005 to increase business confidence and secure ownership rights, a

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new law reduces the period during which commercial deals, including past privatisations, could be contested from the previous ten to three years.

The ongoing reform of competition policy and a better efficiency of the Federal Anti-monopoly Service can also have a positive impact on the business environment, in particular for small and medium-sized enterprises that will see their administrative constraints reduced due to the increased threshold for authorisation and notification.

Notes

1. Iwasaki I., Suganuma K.: "Regional Distribution of Foreign Investment in Russia" in *Post-Communist Economies*, Vol. 17, No. 2, June 2005.
2. In the mid-1990, federal tax remittances ranged from 0 to 67% of total regional tax collection, whereas federal subsidies amounted to 0-100% of regional expenditures. The whole system of fiscal redistribution was subject to *ad hoc* negotiations and political bargaining. See T. Matheson "Does Fiscal Redistribution Discourage Local Public Investment?" in *Economics in Transition*, Vol. 13 (1) 2005, pp. 139-162.
3. For example, in the Republic of Bashkortostan, the following agencies are involved in investment promotion activities: *i)* Agency of the Republic of Bashkortostan for Foreign Investment; *ii)* the Fund for Business Development and Support of Bashkortostan (with 29 offices in towns and districts in the Republic) and *iii)* several different departments in the government of the Republic of Bashkortostan, *i.e.* Council for Business Support in the Cabinet of Ministers; Department of Investment Cooperation in the Ministry of Foreign Economic Relations and Trade of Bashkortostan; Department of Business Development and Department of Investment Policy (both in the Ministry of Economic Development and Industries of Bashkortostan).
4. It is worth mentioning that the Russian notion of SEZ departs from the language applied in most other jurisdictions. In particular, the Chinese SEZ usually mean entities established outside the normal legal and regulatory framework and with a governing board stipulating tax rates, utilities tariffs, regulatory requirements, etc. The Russian SEZ seems to correspond rather to the concept of free economic zones.
5. The IT techno-park specialised in creation of software, envisaged in the initial law proposal, are not mentioned in the final version. However, it is expected that in addition to the two existing categories, the government will propose to establish a third type of SEZ, the so-called tourism or recreational SEZ.
6. The SEZ of Kaliningrad, which was created within the previous SEZ legislation, maintains its SEZ status for 25 years under a separate legislation. The new Federal law on the SEZ in Kaliningrad, adopted on 17 January 2006, confirms customs and fiscal privileges and simplifies the visa delivery system. It also introduces some specific procedures, in particular the status of "SEZ resident" and "investment declaration", which specifies the main parameters of investment projects.
7. Parliamentary hearings on legal support to creation and functioning of SEZ in the Russian Federation, May 2005, available at *www.economy.gov.ru*.
8. See Mark Davis "The Debate on Elimination of Free Enterprise Zones in Ukraine", the *World Bank Note*, 12 December 2005.
9. The federal law "On Concession Agreements" No. 115-FZ of 21 July 2005.
10. *Russian Economic Report*, November 2005, available at *www.worldbank.org.ru*.

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Chapter 4

Forthcoming Legislation on Strategic Sectors

The forthcoming laws on strategic sectors and subsoil will be a test of the government's commitment to transparency and also have important repercussions on foreign investment in Russia. Legislation on strategic sectors should aim at clearly identifying the strategic sectors, limiting the scope of restrictions to foreign control over domestic companies based on a strict interpretation of essential security interests and clarifying the modalities of the government's review and permission procedures, in particular by establishing a specified time limit for notifying the government's decisions.

1. Challenges of the legislation on strategic sectors

1.1. The public debate

A need to identify clearly the sectors in which the state intends to maintain its majority ownership and managerial control in opposition to other sectors with unrestricted foreign entry was first emphasised by President Putin in April 2005 in his annual address to the Parliament. This pledge was interpreted as a favourable gesture towards foreign investors, aimed at reducing present uncertainties. The government under the main responsibility of the Ministry of Industry and Energy and also in co-operation with the Ministry of Economic Development and Trade have been working on a draft bill to be submitted to the Duma in 2006. The debate has concerned three main issues:

- How should strategic sectors be defined? Should the law provide the list of sectors or should it define the guidelines for case-by-case evaluation?
- Should the control concern the level of foreign ownership (*e.g.* imposing a threshold of 50 per cent for foreign participation in sectors concerned) and also include the limitations on the presence of foreigners in the management?
- Who would be responsible for supervising the implementation? It has been proposed to create an interdepartmental agency, which would include the representatives of different governmental agencies (Ministries of Defence, of Economic Development and Trade, the Federal Anti-Monopoly Service) and issue recommendations to be submitted to the Security Council, headed by President of the Russian Federation.

According to the Russian authorities, the proposed law on strategic sectors as currently discussed within the government would cover a few closed sectors and contain a list of approximately 39 sectors, including in particular arms and defence-related sectors as well as nuclear energy and aerospace industries, in which foreign investors would need the governmental authorisation to acquire more than 50 per cent ownership. As for gas and oil sectors, prior authorisation for majority foreign ownership would concern only a limited number of large extraction sites and would be determined by amended subsoil law. A special commission composed by representatives of the main ministries and federal agencies, will be in charge to deliver relevant authorisations and notify them to the applicants within a specified time period (30-60 days in the government's current draft).

In the view of the Russian authorities, the proposed law should not be perceived as a ban on FDI but as an attempt to make the current situation more transparent and predictable and to put the Russian procedures in line with similar legislation adopted in other countries. The new law is expected to be submitted to the Duma by the end of 2006.

1.2. Challenges and opportunities of strategic sectors legislation

In the energy sector, the trend has been clearly towards the consolidation of state ownership and control, though private and possibly foreign minority shareholding has been allowed, for example in Gazprom and in the near future in Rosneft. In some other sectors, commonly considered strategically important by the Russian authorities (such as banking and telecommunications), the entry of foreign investors does not seem to meet major obstacles but the government seeks to control its modalities, in particular by allowing only foreign bank subsidiaries. Moreover several recent consolidation operations in other sectors, such as aircraft, arms and automotive industries, aim at developing major state-controlled companies able to compete internationally. At the same time, increasing foreign ownership has been blocked in other sectors. This situation accentuates the perception of "predictable unpredictability" by foreign investors.[1]

In all countries, the state has the right to take measures on security grounds, but it is sometimes difficult to draw the line between such legitimate safeguards and protectionism. Such risk is not insignificant in Russia where the weight of the public sector is still high,[2] the government's economic interventions are frequent and regulatory control often unpredictable. It is therefore important that the new legislation defines clearly the role of the government, both in terms of the sectoral coverage and the modalities of its intervention, *i.e.:*

- Foreign investment limitations in strategic sectors should be justified by essential security interests and should avoid commercial protectionism favouring domestic economic interests. The sectors concerned should be narrowly defined.
- Modalities for approving or opposing foreign participation should be based on transparent procedures, in particular, specifying whether notification of intented transactions by investors is mandatory or voluntary and establishing a reasonable and clear deadline for notification of government decisions to the applicants.

2. Amendments to the subsoil law

The planned amendments to the law on subsoil[3] has been another awaited important legal piece, which has to clarify the government's involvement in and control over the natural resource sector. The preliminary version of the amended subsoil law published in April 2005 contained several improvements. It envisaged replacing the current licensing system managed often in a non-transparent manner by regional authorities by auction procedures to be set up by the Ministry of Natural Resources. Another proposal was that subsoil contracts negotiated between parties would provide a right of use which as any property right may be transferred. This contrasts with the current law which explicitly forbids transfers to third parties.

In some other areas, the proposed amendments would have, however, a less favourable impact. First, if not clearly defined and sufficiently transparent, the new auction procedures may give a high discretionary power to the Ministry of Natural Resources. Second, the proposed cancellation of the guarantee of automatic extension of licenses would be a step backward compared to current practices. Finally, the possibility for the government to make compulsory purchases of strategic minerals at not necessarily market price adds uncertainty to the deals to be concluded under the new procedures. However, the proposed amendments to the subsoil law have not yet been accepted partly because of the inevitable links of the subsoil legislation with the expected law on strategic sectors and also due to the lack of consensus on proposed changes within the government and the Duma.

Notes

1. Recently, the western companies were able to buy stakes in telecommunications and banking (*e.g.* Raiffeisen International Bank), but for example, Siemens was denied to increase its participation in turbine producer "Siloviye Mashiny" (Power Machine) to over 70% by the Federal Anti-Monopoly Service, which gave later its approval for the sale to the Russian aluminium producer.
2. In 2004, the government share (based on sales) was 24.5% in industry and 20% in transport/ communications and the foreign investment share 5.3% and 1.2% respectively. In the banking sector, the state ownership represented 25.6% of banking assets, whereas the share of banks with foreign participation amounted to 10.8%. See *From Transition to Development*: *A Country Economic Memorandum for theRussian Federation*, p. 145; World Bank 2005.
3. Federal Law No. 2395-1 of 21 February 1992 with subsequent amendments.

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Chapter 5

Russia's International Investment Agreements: An Overview

The bilateral investment treaties (BIT) and increasingly trade agreements containing investment provisions are an integral part of the international investment landscape. Russia has also sought to promote and attract international investment by negotiating investment treaties with its partners. By the end of 2004, the Russian Federation concluded 52 bilateral investment treaties (BIT), of which 35 entered into force. The analysis of the scope and the main provisions of selected Russia's BITs and its Model BIT shows that whereas in a number of areas they follow common OECD practices, they do not do so in some other important areas of investment protection and generally do not contain novel features that characterise OECD international investment agreements.

1. Main features of Russia's selected BITs and its Model BIT

For the purpose of the Review, 22 BITs concluded by Russia (see Table 5.1) and Russia's Model BIT 2001 (as amended in 2002) were analysed. This examination is therefore not a comprehensive review but does provide a cross-section analysis of BITs, covering the treaties concluded with OECD Member States, the Commonwealth of Independent States (CIS) and developing countries since 1989.

The overview shows that Russia's BIT programme in many respects adopts a similar approach as most other BITs. However, there are some disparities among examined BITs, for instance as regards the scope of exceptions to Most-Favoured-Nation Treatment (MFN) and national treatment, assessment of property value for the purpose of compensation for expropriation and the inclusion or not of some provisions such as umbrella clauses, performance requirement and key personnel. With respect to dispute resolution provisions, some examined BITs do not include the clauses on subrogation, consent to arbitration and define differently the scope of arbitration.

Russia's Model BIT follows general BIT practice insofar as it includes provisions on MFN, national treatment, expropriation, free transfer of monies, compensation for damage, subrogation, State-State dispute resolution and investor-State dispute resolution. Differences from common OECD BIT practice are, however, notable in several respects. First, contrary to recent BIT practice, the Model BIT does not appear to extend protection to indirect investors. Second, the provision on exceptions to the standard of national treatment is formulated in a broader manner than is commonly found in BITs. Lastly, the Model BIT does not include a reference to the fair and equitable standard of treatment but provides for "just treatment." The Model BIT does not include an umbrella clause but treatment of umbrella clauses is not uniform in OECD BIT practice either.

Recent trends in international investment agreements have seen the inclusion of provisions relating to entry of key personnel, prohibition of performance requirements, extension of protection to the pre-establishment phase, transparency of laws, transparency of proceedings, third party participation in the dispute resolution process, and consolidation of claims.[1] These novel features are included only in a limited number of Russia's most recent BITs but are not referred to in the Model BIT.

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Table 5.1. **Bilateral Investment Treaties (BIT) concluded by the Russian Federation**

Contracting Party	Date of Signature	Date of entry into force	End of initial period of validity
2001 Model BIT	(Not applicable)	(Not applicable)	(Not applicable)
Armenia	15 September 2001	Not ratified	Initial period of validity of 15 years
Argentina	25 June 1998	20 November 2000	2010
Austria	8 February 1990	1 September 1991	2006
Belgium and Luxembourg	9 February 1989	13 October 1991	2006
Bulgaria	8 June 1993	Not ratified	Initial period of validity of 15 years
Canada	20 November 1989	27 June 1991	No expiration date stipulated
China	21 July 1990	26 July 1991	2006
Croatia	20 May 1996	Not ratified	Initial period of validity of 10 years
Cuba	7 July 1993	8 July 1996	2006
Cyprus	11 April 1997	Not ratified	Initial period of validity of 10 years
Czech Republic	5 April 1994	6 June 1996	2006
Denmark	4 November 1993	28 August 1996	2011
Ecuador	25 April 1996	Not ratified	Initial period of validity of 15 years
Egypt	23 September 1997	13 July 2000	2010
Ethiopia	10 February 2000	6 June 2000	2015
Finland	8 February 1989	14 August 1991	2006
France	4 July 1989	18 July 1991	2006
Germany	13 June 1989	5 August 1991	2006
Greece	30 June 1993	24 February 1997	2012
Hungary	6 March 1995	29 May 1996	2011
India	6 March 1995	29 May 1996	2006
Italy	9 April 1996	27 August 1998	2013
Japan	13 November 1998	27 May 2000	2010
Kazakhstan	6 July 1998	11 February 2000	2015
Korea	14 December 1990	10 July 1991	2006
Korea, DPR	28 November 1996	Not ratified	Initial period of validity of 15 years
Lebanon	8 April 1997	Not ratified	Initial period of validity of 15 years
Lithuania	29 June 1999	29 May 2004	2019
Macedonia, TFYR	21 October 1997	13 July 1998	2008
Moldova	17 March 1998	Not ratified	Initial period of validity of 15 years
Mongolia	29 November 1995	Not ratified	Initial period of validity of 15 years
Netherlands	5 October 1989	20 July 1991	2006
Norway	4 October 1995	21 May 1998	2023
Philippines	12 September 1998	29 November 1998	2013

Table 5.1. **Bilateral Investment Treaties (BIT) concluded by the Russian Federation** *(cont.)*

Contracting Party	Date of Signature	Date of entry into force	End of initial period of validity
Poland	2 October 1992	Not ratified	Initial period of validity of 15 years
Portugal	21 July 1994	Not ratified	Initial period of validity of 15 years
Romania	29 September 1993	19 July 1996	2011
Serbia and Montenegro	11 October 1995	8 July 1996	2011
Slovakia	30 November 1993	2 August 1995	2011
Slovenia	8 April 2000	Not ratified	Initial period of validity of 10 years
South Africa	23 November 1998	12 April 2000	2015
Sweden	19 April 1995	7 June 1996	2016
Switzerland	1 December 1990	26 August 1991	2006
Syrian Arabic Republic	8 April 2000	Not ratified	Initial period of validity of 10 years
Thailand	17 October 2002	Not ratified	Initial period of validity of 15 years
Turkey	15 December 1997	17 May 2000	2015
Ukraine	17 November 1998	27 January 2000	2010
United Kingdom	6 April 1989	3 July 1991	2006
United States	17 June 1992	Not ratified	Initial period of validity of 10 years
Uzbekistan	22 December 1997	Not ratified	Initial period of validity of 10 years
Vietnam	16 June 1994	3 July 1996	2011
Yemen	17 December 2002	Not ratified	Initial period of validity of 15 years

Note: The BITs reviewed in this study are highlighted.

2. Main provisions of Russia's BITs

This section examines main provisions of selected Russia's BITs and its Model BIT. Table 5.2 summarises the main points of this analysis and provides additional details.

2.1. Preamble, promotion and admission of investment

The BIT Preambles outline the object and purpose of a treaty and can be used as a tool in treaty interpretation. The Russian BITs examined in this study all make reference to economic development or cooperation. Twelve of these BITs additionally make reference to the creation or strengthening of scientific and technical cooperation. Three early BITs entered into with OECD Member States make reference to fair and equitable treatment. The most expansive preamble can be seen in the 1992 Russia-United States BIT which

Table 5.2. **Summary of main provisions of Russia's BITs reviewed in this study**

Main BIT provisions	General Description	Comments
Preamble	Outlines the object and purpose of a treaty and is used as a tool in treaty interpretation	• All BITs refer to economic development or cooperation. • Model BIT and 11 BITs additionally refer to scientific and technical cooperation (Cyprus, Egypt, Ethiopia, France, Japan, Kazakhstan, Lebanon, Lithuania, Netherlands, South Africa, Turkey).
Jurisdiction		
Temporal scope	Delineates the time period of application of the BIT	• Narrower coverage in the Model BIT • 7 of 22 BITs reach the end of their initial period of validity within the next two years (Belgium-Luxemburg, France, Germany, Korea, Netherlands, Switzerland, UK)
Definition of "investor" and definition of "investment"	Who and what benefits from the treaty protections	• Japan-Russia BIT covers a broad class of juridical persons • All BITs refer to place of incorporation to determine corporate nationality; some BITs restrict coverage by additionally including a "real economic activities" criterion (Ethiopia, Switzerland, Thailand, Egypt)
Substantive Protections		
Most Favoured Nation Treatment	Treatment will be not less favourable than that accorded to investors of any third state	• Model BIT and 18 BITs restrict scope to "disposal and management" or similar formulations (Cyprus, Sweden, Thailand, Lithuania, Netherlands, Canada, Ethiopia, France, Germany) • Broad formulation used in Belgium and Luxembourg-Russia BIT 1989 • The application of the MFN provision not expressly qualified (Korea, Norway, Switzerland, Turkey, Ukraine, UK, US)
National Treatment	Treatment will be not less favourable than that accorded to a Party's own investors	• No national treatment standard in BITs concluded with Belgium and Luxembourg, Germany, Netherlands and Switzerland
Exceptions to MFN or national treatment		• Model BIT reserves the right to introduce or apply exceptions to the national standard of treatment without qualifying the scope of this derogation • The Japan-Russia BIT allows pre-investment discrimination only for national security reasons • Model BIT and 9 BITs also exclude treatment granted under agreements with the CIS (Cyprus, Egypt, Japan, Lebanon, Norway, South Africa, Sweden, Thailand, Turkey)

Table 5.2. **Summary of main provisions of Russia's BITs reviewed in this study** *(cont.)*

Main BIT provisions	General Description	Comments
Fair and Equitable Treatment	A standard of treatment applicable to foreign investors regardless of the standard of treatment accorded by a State to its own nationals	• Model BIT provides for "just treatment" • Ukraine-Russia BIT does not contain this standard of treatment • "Fair and equitable treatment" (Belgium-Luxemburg, Canada, Cyprus, Ethiopia, France, Kazakhstan, Korea, Lebanon, Lithuania, Netherlands, Norway, Sweden, Switzerland, Thailand, Turkey, UK, US); "just and equitable treatment" (Egypt, Japan and South Africa)
Expropriation	States have the sovereign right to expropriate property, however, the manner in which this right is exercised is conditioned by provisions in BITs	• UK-Russia BIT does not make reference to a due process requirement • Ukraine-Russia BIT does not make reference to a public interest or due process requirement • 4 BITs do not use the requirements under customary international law (Belgium-Luxemburg, Germany, France, Switzerland) • Model BIT stipulates compensation may be freely transferred to the territory of the other Contracting Party • Japan-Russia BIT does not contain a clause on the imposition of interest
Free Transfer	A clause reducing or eliminating restrictions on monetary transfers arising in connection with investment	• All 23BITs provide for free transfer of payments • 2 BITs appear to provide an exhaustive list of payments (Belgium-Luxemburg, Korea) • 3 provide for balance of payment safeguards (Japan, Canada, US)
Umbrella Clause	Operates to elevate contract breaches into treaty breaches	• No umbrella clause in Model BIT and in the following BITs: Belgium-d Luxembourg, Canada, Cyprus, Egypt, Ethiopia, Kazakhstan, Lebanon, Lithuania, Norway, South Africa, Sweden and Ukraine • Umbrella clause included in the following BITs: France, Germany, Japan, Korea, Netherlands, Switzerland, Turkey, UK, US
Other Provisions		
Compensation for Damage	Stipulates when a State is obliged to pay compensation for damage	• Model BIT and 22 BITs: compensation due if the host State provides compensation to its own nationals and/or nationals of a third state
Performance requirements and key personnel	Operate to eliminate the imposition of performance requirements in undertaking the investment and permit entry of key personnel in connection with the investment	• Prohibition of performance requirements only included in BITs concluded with Japan, Switzerland and US • 6 BITs provide for entry of key personnel (Egypt, Lithuania, Turkey, Kazakhstan, South Africa, US) • Model BIT does not refer to either

Table 5.2. **Summary of main provisions of Russia's BITs reviewed in this study** *(cont.)*

Main BIT provisions	General Description	Comments
Transparency	Provide for transparency of domestic laws and regulations affecting investment	• Included in the majority of recently concluded BITs (Egypt, Japan, Kazakhstan, Lebanon, Lithuania, South Africa, Turkey, Ukraine, US) • Not included in Model BIT
Dispute Resolution		
Subrogation Clause	Allows for an investor to claim under an insurance contract without prejudice to the claim	• Not included in 1997 Cyprus-Russia BIT
State-State Dispute Resolution	Stipulates the mechanism for settlement of disputes between the Contracting Parties	• No State-State dispute resolution in Japan-Russia BIT
Investor-State Dispute Resolution		
Consent to arbitration	Consent of both parties to the dispute is a necessary prerequisite to arbitration. Consent of the State may be explicitly or implicitly included in a BIT	• 3 BITs contain an explicit consent to arbitration clause (Ethiopia, Netherlands, US) • In others consent must be implied from the wording of the treaty (Belgium-Luxemburg, Cyprus, Egypt, Germany, Japan, Kazakhstan, Korea, Lebanon, Lithuania, South Africa, Sweden, Thailand, Turkey, Ukraine, UK)
Scope of dispute resolution clause	Only disputes that fall within the scope of consent to arbitration may be heard by an arbitral tribunal	• Consent to arbitration of "any" or "all": Canada, Cyprus, Egypt, Ethiopia, France, Kazakhstan, Lebanon, Lithuania, Norway, South Africa, Sweden, Thailand, Turkey, Ukraine • 6 early BITs contain narrower dispute resolution clauses (Belgium-Luxemburg, Germany, Korea, Netherlands, Switzerland, UK) • Japan: : any "legal dispute" arising between the parties • US: the broadest dispute resolution clause • Model BIT: provides merely for "disputes .. arising in connection with capital investments" – see Article 8(1)
Pre-requisites to arbitration	Stipulations as to necessary formalities/procedures that must be observed before an arbitral tribunal may assume jurisdiction over a dispute	• 6 month waiting period: all BITs except 3 (see below) and Model BIT • Japan: no specific period • 3 month waiting period: Korea, UK

Table 5.2. **Summary of main provisions of Russia's BITs reviewed in this study** *(cont.)*

Main BIT provisions	General Description	Comments
Choice of venue	A list of venues in which an investor may raise a claim under a BIT	• 9 BITs provide for arbitration under the Stockholm Chamber of Commerce (Belgium-Luxemburg, Cyprus, Lebanon, Lithuania, Norway, South Africa, Turkey, UK) • 3 BITs do not specify any arbitral forum and have detailed provisions on appointment of arbitrators, procedures and costs (Germany, Netherlands, Switzerland) • Model BIT and 2 BITs provide for ICSID arbitration (Japan, US) • All other BITS: arbitration under the Rules of the UN Commission on International Trade Law (UNCITRAL)
"Fork in the road"	A provision that the investor's choice of forum is final and exclusive	• 2 BITs: explicit "fork in the road" clause (Japan, US) • 10 (recent) BITs and Model BIT: permit investors to refer to the national courts *or* arbitration (implicit fork in the road) (Cyprus, Egypt, Ethiopia, Kazakhstan, Lebanon, Lithuania, South Africa, Thailand, Turkey, Ukraine) • 10 (earlier) BITs: no mention of exhaustion of domestic remedies (Belgium-Luxemburg, Canada, France, Germany, Korea, Netherlands, Norway, Sweden, Switzerland, UK
Third party participation, openness of proceedings and consolidation of claims	Provisions providing for the participation of non-disputing parties in the arbitral proceedings, publication of awards and consolidation of claims (where relevant)	• Japan-Russia BIT provides for non-disputing State Party to submit comments • No inclusion in Model BIT

makes reference to economic cooperation, protection of internationally recognised rights of workers and promotion of free market principles.

The majority of BITs contain, in the first set of provisions, an Article providing for promotion and admission of investments by investors of one Contracting Party into the territory of the other Contracting Party. A common feature of this type of clause is to recognise the right of States to condition entry of aliens and alien property on compliance with domestic laws and regulations. All of the Russian BITs examined in this study are consistent with this approach. It is also common for such provisions to recognize the right of States to exclude foreign investment in certain sectors. This approach can be seen in BITs concluded with Egypt, Kazakhstan, Lebanon, Lithuania, South Africa, Ukraine and Japan. No qualifications are introduced to limit the scope of application of this provision, except in the Japan-Russia BIT, according to which the Contracting Parties reserve the right to exclude or restrict foreign investment only where necessary for national security reasons (see Protocol, Article 5). Decisions by the State on admission of investments commonly fall outside the scope of the dispute resolution provisions. Recent BIT practice of some OECD States has sought to attach a standard of treatment to the admission of investments. Two of the BITs reviewed, those concluded with Japan and Turkey, expressly attach the most favoured nation standard of treatment. Such a provision, however, has not been repeated in the Model BIT.

2.2. Scope of application

2.2.1. Territorial and temporal scope

A treaty will typically define its scope of application by defining its subject matter, territorial, temporal jurisdiction and, where applicable, the class of persons benefiting from its provisions. The Russian BITs reviewed generally define their territorial and temporal scope in a manner consistent with dominant trends in BIT practice through applying the treaty provisions to all territories over which it exercises sovereign rights and over an initial, renewable, period of time (ordinarily from ten to fifteen years). Notably, 7 of the 22 BITs analysed in this study will reach the end of their initial period of validity within the next two years. The Model BIT is exceptional insofar as it limits its scope of application to investments made after the treaty has entered into force. This temporal limitation is not included in any concluded BITs under review in this study.

2.2.2. Definition of investment and investor

BITs typically contain a definition section detailing those investments and investors covered by the treaty. All of the Russian BITs analysed in this study follow the long-standing practice in defining "investment" through providing a broad "asset based" definition followed by a non-exhaustive list of protected investments. Similarly, the Russian BIT programme is facially consistent with the dominant trend in defining an investor and extends protection to both natural and juridical persons.

Nationality of juridical persons for the purposes of BITs is typically determined according to place of incorporation, principal seat of the enterprise or through the notion of control. All of the Russian BITs examined in this study, including the Model BIT, identify the place of incorporation as the determinative criteria. Seven of the BITs concluded by Russia, including those concluded with Cyprus and Japan, *prima facie* provide a narrower definition through additionally requiring the principle seat of the corporate entity to be within the territory of the relevant Contracting Party. A restrictive definition of investor can be seen in some of the Russian BITs reviewed, notably in its recent treaty practice, which additionally require the "real economic activities" of the enterprise be within the territory of the relevant Contracting Party.[2]

A certain number of investment protection instruments also extend protection to indirect investments either through a broad definition of investment or a broad definition of investor. Of the BITs examined in this study, eight extend protection to indirect investments through a broad definition of investment. The Switzerland-Russia BIT contains a separate "scope of application" Article extending treaty protections to indirect investors. The Japan-Russia BIT extends protection to indirect investors through according treaty protections to "business related investment activities," the definition of which includes "controlling and managing companies founded or acquired by investors." However, in contrast with trends in recent BITs concluded by OECD Members,[3] protection of indirect investments is not apparent in Russia's recent BIT practice and is notably absent from the Model BIT.

2.3. Substantive protections

Investment protection treaties traditionally contain a common core of substantive protections, including fair and equitable treatment, non-discrimination, most favoured nation treatment, compensation for expropriation and free monetary transfers. The coverage of the BITs concluded by Russia does not, *prima facie*, depart from these protections, but in some cases their exact formulations differ from usual practices.

2.3.1. National Treatment (NT) and Most Favoured Nation Treatment (MFN)

National Treatment and Most Favoured Nation Treatment form core obligations in BITs and are found in the vast majority of BITs and other investment instruments.[4] These are often described as "contingent" standard of treatment insofar as the level of protection accorded is dependent on treatment accorded to third parties, either nationals of a Contracting Party or investors from third States. A typical provision can be seen in Article 3(2) of the Cyprus-Russia BIT which provides that the treatment accorded to foreign investment or investors "shall not be less favourable than that granted with regard to investments and activities in connection with investments by its own investors or investors of any third state."

The Japan-Russia BIT contains novel features in relation to its most favoured nation and national treatment provisions. In addition to an independent article providing for MFN and national treatment, these two standards are repeated in the provisions providing for substantive protections. Reference to MFN and national treatment can be seen in provisions relating to expropriation, money transfers, compensation for damage and access to judicial remedies. The overall scheme of MFN and national treatment protection is not commonly found in BITs, however, it does reflect discernible trends in the Japanese BIT programme.

While variations in language and drafting can be seen in the Russian BITs, all the treaties analysed in this study provide for the most favoured nation standard of treatment. The scope of the MFN provisions is restricted in a number of BITs concluded by Russia through qualifying its application to the "disposal and management", as in the Model BIT, or "management, maintenance, use, enjoyment and disposal." A much broader formulation used in the 1989 Belgium and Luxembourg BIT which provides that the MFN provision relates to: "toutes les matières visées au présent Accord". The BITs with Korea, Norway, Switzerland, Turkey, Ukraine, the United Kingdom and the United States do not expressly qualify the application of the MFN provision. While the use of MFN clauses is prolific in international investment agreements, no universal practice in respect of their scope is discernible.[5]

The standard of national treatment appears to be contained in the majority of BITs. Concurrent with this trend, the Russian BIT programme provides for national treatment in the majority of the BITs examined in this study. While slight variations in drafting exist between the Russian BITs, the most commonly used formulation to express this standard is treatment "no less favourable" than that accorded by a Contracting Party to its own investors. A feature of some BITs, in particular recent Canadian and US practice, is to stipulate that national treatment involves a comparison between domestic and foreign investors in "like" or "similar" circumstances. This approach can be seen only in the 1997 Egypt-Russia BIT which contains a "similar investments" test. All other BITs reviewed here, including those concluded with Canada and the US and the Model BIT, do not contain a "likeness" test.

Exceptions to MFN treatment or the national standard of treatment are also a relatively common feature in BITs. The most common exceptions relate to free trade areas, customs unions, common markets and agreements on taxation matters, in particular double taxation agreements.[6] Of the BITs examined in this study, only the Japan-Russia BIT contains no reference to a free trade area or customs union and only the Switzerland-Russia BIT contains no reference to taxation matters. Ten of the BITs examined in this study, including the Model BIT, also exclude treatment granted under agreements with the republics of the former USSR.

Exceptions to national treatment appear with relative frequency in BITs. Of the 19 BITs examined in this study that contain a provision on national treatment, 15 contain derogations to this standard although the scope of these derogations varies.[7] Two approaches are discernible in the Russian BIT programme. The first approach is to reserve the right to apply or introduce exceptions to national treatment (post-establishment discrimination). The second approach excludes foreign participation in certain sectors of the economy or spheres of activity (pre-establishment discrimination). The two approaches have the effect of permitting discriminatory treatment of foreign investors.

The Model BIT, employing the first approach, explicitly reserves the right to introduce or apply derogations from national treatment without limiting the scope of this provision [see Article 3(3)]. A narrower formulation can be seen in the 2002 Thailand-Russia BIT which limits the application of exceptions to national treatment to measures necessary for national security or public order.[8] Restricting these exceptions to specified sectors or for specified purposes is more consonant with general BIT drafting practice. By contrast, however, the Model BIT appears to provide the possibility of wide ranging exceptions to national treatment.

2.3.2. Fair and Equitable Treatment

The fair and equitable standard of treatment prescribes an absolute standard of treatment to be accorded to foreign investors or foreign investments, *i.e.* the level of treatment is not contingent on treatment accorded to third parties and is virtually ubiquitous in foreign investment protection instruments.[9] The vast majority of the BITs analysed in this study provide for "fair and equitable treatment", with the exception of the Ukraine-Russia BIT. A notable departure from general investment protection practice is the formulation employed in Article 3(1) of the Model BIT which provides simply for "just treatment", omitting the term "fair and equitable".

2.3.3. Expropriation

It is well recognised by international law that the right to expropriate property falls within the sovereign powers of a State. Customary international law and the vast majority of BITs, however, condition the exercise of this right on expropriation being non-discriminatory, taken under due process of law, for a public purpose and against the payment of compensation.[10] The standard of compensation is predominantly expressed in terms of *the Hull Formula*, *i.e.* "prompt, adequate and effective."[11] Other relatively standard features of BITs are: *i)* protection against both direct and indirect expropriation,[12] *ii)* ensuring that compensation is paid without undue delay, in a freely convertible currency and is freely transferable and; *iii)* stipulating the standard of valuation of the affected property. It is also not uncommon to find stipulations relating to the imposition of interest, although a great disparity exists with respect to the precision of these clauses. The newest generation of BITs, in particular the US and Canadian Models, have sought to draw a distinction between expropriation and regulatory takings that do not give rise to compensation.[13] This feature, however, is not present in the Russian Model BIT or any of the concluded BITs under review.

While the Russian BIT programme does not appear to deviate greatly from the norm, a few points of interest may be raised, in particular with respect to the Model BIT. As a preliminary point, it should be noted that all of the BITs examined in this study protect against both direct and indirect expropriation. On all other points, however, differences can be seen between the various BITs (see Table 5.2).

The standard of valuation used in the BITs examined in this study varies. The most commonly used formulations are "real value" and "market value." More important, however, is the distinction relating to the date on which the property value will be assessed. Two general trends are apparent in the Russian BIT programme. Under one approach, the valuation date will be "immediately before the expropriation or before impending expropriation became *public knowledge*..."[14] (emphasis added). A more restrictive formulation has, however, been used in the Model BIT insofar as the relevant date is the date of expropriation or when the impending expropriation was "officially announced".[15] Both these dates of valuation appear with relative frequency in general BIT practice and, consequently, no dominant trend in general BIT practice can be readily identified with respect to the date of valuation. This notwithstanding, the date of valuation can have important consequences on the level of compensation owed to an investor in cases of expropriation.

Another relatively standard provision in BIT practice is a clause providing for compensation to be paid without undue delay, in a freely convertible currency and be freely transferable. The majority of the Russian BITs examined in this study include such a provision. The Model BIT contains a moderately narrower provision in that it stipulates compensation shall be "freely transferred from the territory of one Contracting Party to the territory of the other Contracting Party".[16]

The majority of the BITs examined in this study contain a clause on the imposition of interest on the compensation. Within these BITs, however, the specificity, if any, of these clauses vary with respect to the date on which interest will start to accrue and the applicable rate of interest. The Model BIT provides a relatively high level of specificity: "*From the time of nationalisation to the time of payment interest shall accrue on the amount of compensation at a commercial market rate but not below LIBOR for six month dollar credits*." By contrast, the Japan-Russia BIT does not include any provision on interest. This omission will not *ipso jure* or *ipso facto* negate the possibility of imposition of interest, rather the question will fall within the discretionary powers of the arbitral tribunal should an arbitration be initiated.

2.3.4. Free Transfer

The free transfer of payments is a fundamental aspect of investment protection and is considered a core element in investment protection instruments. While on the one hand, financial regulation falls within the sovereign domain of States, provisions in BITs providing for free transfer of payments operate to enable investors to repatriate, *inter alia*, capital and returns on investments. These clauses typically provide a non-exhaustive list of protected transactions. All of the BITs surveyed in this study provide for free transfer of payments.

A further notable feature is the explicit reference to safeguards in case of the balance-of-payment difficulties (Japan-Russia BIT, Canada-Russia BIT and US-Russia BIT). Such balance-of-payment provisions are not present in the majority of BITs but have become more frequent in recent OECD member agreements.

2.3.5. Umbrella Clauses

Umbrella clauses operate to elevate contract breaches into breaches of international law. Such clauses are thought to be present in approximately 44 per cent of BITs.[17] Within the Russian BIT programme reviewed in this study, 43 per cent of the BITs contain an umbrella clause, in particular the treaties concluded in 1989/90 as well as the 2002 Thailand-Russia BIT (not in force) and the 1998 Japan-Russia BIT. However, no umbrella clause is included in the Cyprus-Russia BIT or the Model BIT.

2.3.6. Compensation for Damage

The vast majority of BITs provide protection against loss arising from, *inter alia*, war, other armed conflict or a state of national emergency. Compensation is ordinarily due to investors in the event the host State provides compensation to its own nationals or nationals of a third state. Article 5 of the Model BIT is consistent with the predominant approach.

2.3.7. Performance Requirements and Key Personnel

Performance requirements relate to the imposition by a State of conditions on the manner in which the investment is carried out. These requirements may take the form of, amongst others measures, export restrictions, local supply requirements or employment of local personnel requirements. Only a minority of BITs concluded by Russia contain a prohibition on performance requirements, more specifically those concluded with Japan, Switzerland and the United States.

Related to the question of performance requirements is the issue of entry of key personnel. Provisions allowing for the entry of personnel have been increasingly included in recent BITs, including for example the most recent French, Canadian and US Model BITs. Six BITs, the majority of which have been recently concluded, contain provisions allowing for the entry of personnel. Only two of these BITs (Lithuania and Kazakhstan) provide a definition of what is understood by "key personnel". The new Russian Model BIT contains no reference to prohibition of performance requirements or entry of personnel.

2.3.8. Transparency

Transparency requirements can be described as a novel feature of the newest generation of BITs. Transparency requirements appear in the 1992 US-Russia BIT and in all Russia's BITs concluded since 1997 (except 2000 Ethiopia BIT and 2002 Thailand BIT). However, the Russian Model BIT does not contain a provision on transparency of laws.

2.3.9. Subrogation clauses

Subrogation clauses are an important element in the dispute resolution process and are found in the vast majority of BITs. These clauses enable investors to claim under their insurance contracts for any harm suffered without prejudice to the claim against the state and allow the insurer to "stand in the shoes" of the investor. Within the Russian BIT programme reviewed, a distinct subrogation clause is absent only in the Cyprus-Russia BIT.

2.4. Dispute Resolution Provisions

2.4.1. State-State dispute resolution

State to State dispute resolution provisions are a common feature in BITs. Little variation is seen between the provisions which ordinarily provide for settlement through negotiations or diplomatic channels; failure in either case means the Parties may initiate binding arbitration. The majority of the Russian BIT programme analysed in this study follows the same general approach. The Japan-Russia BIT is an exception as it contains no provision on resolution of inter-State disputes.[18]

2.4.2. Investor-State dispute resolution

Russian BIT practice is somewhat unclear and appears to vary as to whether and to what extent investor-State dispute settlement is provided for nor is a dominant trend in this area discernable. Arguably, the most important feature of a bilateral investment treaty is the investor-State dispute resolution provision which enables the investor to directly assert the rights and benefits accorded under the treaty. The important elements to consider in a dispute resolution clause are: *i)* the existence of consent to arbitration; *ii)* the scope of the consent to arbitration; *iii)* any applicable pre-conditions to arbitration and waiting periods; *iv)* the forum(s) for dispute resolution; *v)* whether the dispute resolution clause contains a "fork in the road" and; *vi)* whether the BIT eliminates the requirement to exhaust domestic remedies.

Unlike domestic judicial remedies, the arbitral process is a consensual process. Consequently, it is a prerequisite to arbitration that both parties have consented to have their dispute heard by an arbitral panel. A **clause containing an explicit consent to arbitration** has traditionally been included in US BITs and has become more prevalent during the 1990's. Within the Russian BIT programme reviewed, only three concluded BITs contain such a clause (with the US, Ethiopia and the Netherlands). Where no such clause is present, consent to arbitration must be implied from the wording of each individual provision. A strong presumption of consent can be derived from the wording of the 1990 Korea-Russia BIT, Article 9(2) which states that if no amicable settlement is reached, the dispute "*shall be submitted by the investor to arbitration.*" By contrast, the Model BIT and the BITs concluded with Japan and Cyprus use the term "may" rather than "shall."

The **scope of the dispute resolution clause** is critical to the arbitral process. Arbitral jurisdiction is limited to matters that fall within the consent to arbitration as expressed in the arbitration clause. The majority of the Russian BITs reviewed, including the Model BIT, follow standard practice and consent to arbitration of "any" or "all" disputes. The Japan-Russia BIT uses language which echoes the ICSID Convention and refers to any "legal dispute" that arises between the parties. Six BITs entered into with Russia during 1989/90 contain very narrow dispute resolution clauses. These BITs limit consent to arbitration to the amount of compensation for expropriation and its method of calculation, articles on free transfer of monies and compensation for damage. The wording of the Russian Model BIT leaves open the question of what disputes may fall under the arbitral jurisdiction, *i.e.* whether it covers

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only disputes relating to allegations of violation of the substantive provisions of the BIT or whether it also covers disputes relating to investment agreements or contracts. The relevant provision merely provides for arbitral jurisdiction over "disputes … arising in connection with capital investments".[19]

All of the BITs reviewed in this study, and in line with general trends in BIT practice, pre-condition recourse to arbitration on an attempt to reach an amicable settlement. Most BITs under review and the Model BIT Article 8(2) stipulate 6 month **waiting period** with exceptions of the 1998 Japan-Russia BIT (which does not specify it) and the BITS with Korea and the United Kingdom, which both prescribe a 3 month period.

Consistent with general BIT practice, the majority of the Russian BITs examined include a **choice of venue clause**. All the BITs provide for *ad hoc* arbitration, the majority of which stipulate arbitration under the Rules of the United Nations Commission on International Trade Law (UNCITRAL). Nine of the BITs reviewed additionally provide for arbitration under the auspices of the Stockholm Chamber of Commerce (SCC). The US-Russia BIT, Japan-Russia BIT and the Model BIT provide for arbitration under the auspices of ICSID and the ICSID Additional Facility Rules. As Russia has yet to ratify the ICSID Convention only the reference to the Additional Facility Rules is, at present, of any practical value.

Another issue to be considered is whether the dispute resolution provisions contain a "**fork in the road**" **clause**, *i.e.* whether resort to international arbitration and resort to domestic judicial procedures are mutually exclusive. Within the Russian BIT programme reviewed, explicit fork in the road provisions can only be seen in the Japan-Russia BIT and US-Russia BIT. Early Russian BITs make no mention of exhaustion of domestic remedies; however, the most recently concluded BITs and the Model BIT permit investors to refer their disputes to the national courts *or* arbitration.[20]

Recent OECD members BIT practice has seen the emergence of provisions providing for, *inter alia*, **third party participation**, openness of proceedings and consolidation of claims. Of the BITs reviewed, only the Japan-Russia BIT contains any such novel features; Protocol, Article 5 provides for the submission of comments by the non-disputing State Party in disputes raised under the Treaty. This provision has not been repeated in the Model BIT, nor has this latter instrument included some of the more novel features of recent BIT practice.

3. Other Sources of International Protection of Investment

In addition to bilateral investment treaties, Russia's obligations towards foreign investment may arise from other international instruments and domestic legislation. An important part of the arbitral process is the recognition and enforcement of awards. Russia has undertaken international obligations in this respect through signature and ratification of the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Russia's membership in the Council of Europe and ratification of that Council's instrument, the 1950 European Convention on the Human Rights, may also give rise to important investment protections. Russia has signed but not ratified the Energy Charter Treaty, a multilateral, sectoral investment protection instrument, making its obligations under this instrument unclear.

3.1. Enforcement of Arbitral Awards: The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958 and Immunity from Execution

The New York Convention is an international treaty with 164 Contracting Parties which places an international public law obligation on State Parties to recognise and enforce foreign arbitral awards.[21] For any award rendered other than under the auspices of ICSID, this Convention provides the legal mechanism for enforcement of the arbitral award. Its relevance to the Russian legal regime for foreign investment protection is high, given Russia's non-ratification of the ICSID Convention. Russia ratified the New York Convention on 24 August 1960 but entered a "reciprocity reservation"; in other words, the Russian Federation has undertaken to enforce the New York Convention only with respect to awards rendered in the territory of another Contracting State.

The obligation to recognise and enforce arbitral awards is not, however, unqualified. Article V grants certain narrow grounds on which the domestic courts may legitimately refuse recognition or enforcement of an award. Commentators have raised concerns on the manner in which the Russian domestic judiciary has interpreted these grounds, arguing that it has demonstrated a greater willingness to refuse recognition and enforcement of awards than is generally accepted as appropriate.[22] This apparent trend has developed since the early 1990's. It is however difficult to determine the number of un-enforced awards with any degree of accuracy as few judicial decisions are readily available for public scrutiny.[23]

Another mechanism that may act as a barrier to enforcement of arbitral awards against a State is the principle of immunity. While it is often understood that entering into an arbitration agreement implicitly includes a waiver of immunity from suit, it does not follow that the State has waived immunity from execution. Commentators have expressed concern over Russia's use of immunity arguments to prevent attachment of property and hinder enforcement of awards.[24] Difficulties faced in respect of recognition and enforcement of awards in and against Russia risks reducing investor confidence in an effective investment protection regime in Russia.

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3.2. The European Convention on Human Rights

The 1950 European Convention on Human Rights (ECHR) forms an important element in the legal protection of foreign investment.[25] This Convention is notable both for the breadth of protections offered and the sophisticated mechanism used in its enforcement, the European Court of Human Rights.

In 2004 Russia had the highest number of applications lodged against it, with 6691 applications lodged, a figure well above that for any other State. In 2005, 174 Judgements and Decisions were rendered in cases involving Russia of which 75 cited Article 1, Protocol 1. A number of cases arising out of the Yukos affair will be heard in this venue.[26]

3.3. The Energy Charter Treaty

The Energy Charter Treaty (ECT) is a multilateral instrument which applies specifically to the energy sector. Signed in 1994 and entered into force in 1998, it has the potential to form an important part of the investment protection regime.[27] At present, the Russian Federation has signed but not ratified the Treaty; the consequences that flow from this position are unclear. Article 45 of the ECT provides for provisional application of the Treaty in the interim period between signature and ratification. This is an unusual provision in treaty practice and its full implications remain uncertain and untested, particularly with respect to the investor-State dispute resolution provisions. Yukos shareholders have reportedly initiated arbitration under the ECT, seeking compensation for the drop in share price resulting from governmental action taken against the firm.[28]

3.4. The EC-Russia Partnership and Cooperation Agreement

The EC-Russia Partnership and Cooperation Agreement, which entered into force on 1 December 1997, puts in place a framework for cooperation in a variety of fields and has as its final objective the establishment of a EC-Russia Free Trade Area.[29] This instrument is complemented by a series of sector specific agreements and other cooperation agreements. The Agreement contains a Chapter on "Business and Investment" which includes provisions on labour conditions, establishment of a business, entry of key personnel, free transfer of capital, balance of payment and other financial safeguards, most favoured nation treatment, national treatment and exceptions thereto. While some of these provisions are drafted in mandatory terms, others appear to require merely a "best endeavour" to achieve certain goals, such as a liberalisation of establishment of an enterprise (Article 34). Unlike the other instruments reviewed in this study, investors are not accorded a direct right of action to assert protections provided by this Agreement; disputes as to the application and interpretation of the Agreement are settled only at the inter-State level.

4. Significance of Russia's BITs for protection of foreign investment

Russia's BIT programme has evolved as a number of provisions in most recent BITs are often better defined than those contained in earlier BITs signed at the beginning of 1990s. However, Russia's last BIT Model, generally ignores recent innovations. In some cases, its definitions and/or omissions seem to lessen the guarantees and protection to foreign investors commonly found in OECD members' agreements. Moreover, even the latest Russian BITs do not embody most of novel features that characterise OECD and other countries' recent BITs. It could therefore be considered that Russia's current BITs are more reminiscent of the "first generation" of international investment treaties.

Russia's existing BITs cover some 40 per cent of Russia's total inward and 15 per cent of outward foreign direct investment stock. This can be compared for example to Turkey (89.4 per cent of inward and 73.7 per cent of outward FDI covered by BITs and trade agreements), Poland (94.4 per cent of inward FDI and 87.6 per cent outward FDI) or Japan (3.6 per cent inward and 11.5 per cent outward FDI).[30]

Notes

1. Novel Features in OECD countries' Recent Investment Agreements: An Overview; available at: *www.oecd.org/daf/investment/agreements*.
2. See BITs concluded with Ethiopia (2000); Switzerland (1990); Thailand (2002) and Egypt (1997), which use the terminology "currently operating on the territory of this Contracting Party" at Article 1(1)(a).
3. See "Stocktaking of Developments in Investment Agreements: Preliminary Results"; DAF/INV/WD(2005)10; paragraph 49.
4. See "Stocktaking of Developments in Investment Agreements: Preliminary Results", DAF/INV/WD(2005)10, Tables 1 and 2.
5. Houde M-F and Pagani, F, *Most-Favoured Nation Treatment in International Investment Law,* in "International Investment Law: A Changing Landscape", OECD, September 2005.
6. See "Stocktaking of Developments in Investment Agreements: Preliminary Results", DAF/INV/WD(2005)10; pages 30-31.
7. No exclusion from the national standard of treatment is found in BITs concluded with Ethiopia (1997), France (1989), Turkey (1997) and the United Kingdom (1989).
8. A similar formulation can be seen in Article 3(3) Sweden-Russia BIT which allows for the imposition of exceptions to the national standard of treatment with respect to existing legislation but restricts the ability of the Contracting Parties to introduce new exceptions except where necessary "for the purpose of the maintenance of defence, national security and public order, protection of the

environment, morality and public health." The US-Russia BIT 1992 Article II(1) follows US BIT practice and allows for the introduction and maintenance of exceptions with respect to sectors or matters listed in an Annex.

9. Considerable debate exists over where the threshold of treatment is set, in particular in relation to the minimum standard of treatment as defined by customary international law. See C. Yannaca-Small, *Fair and Equitable Treatment Standard in International Investment Law* in "International Investment Law: A Changing Landscape", OECD, September 2005.

10. The majority of the BITs reviewed, including the Model BIT, include these requirements. However, the United Kingdom-Russia BIT makes no reference to the due process requirement and the Ukraine-Russia BIT omits any reference to both the public interest and due process requirements.

11. The standard of compensation is predominantly expressed in terms of the Hull Formula in the BITs reviewed. More recently concluded BITs and the Model BIT employ the Hull Formula or largely equivalent formulations.

12. A number of formulations are used to protect against indirect expropriation such as measures "tantamount to expropriation,""having a similar effect to expropriation" or "being equated in consequence to expropriation".

13. C. Yannaca-Small, *Indirect Expropriation and the Right to Regulate in International Investment Law,* in "International Investment Law: A Changing Landscape", OECD, September 2005.

14. Article 5(1) Korea-Russia BIT. See also BITs concluded with Belgium and Luxembourg (1989); Egypt (1997); Ethiopia (2000); France (1989); Lebanon (1997); Lithuania (1999); Thailand (2002); Turkey (1997); the UK (1989) and the US (1992).

15. Article 4(1) Model BIT 2001. See also BITs concluded with Germany (1989); Japan (1998); Kazakhstan (1998); South Africa (1998); Ukraine (1998) and Cyprus (1997).

16. See also BITs concluded with Egypt (1997) and Lithuania (1999).

17. See Gill, Gearing and Birt, *Contractual Claims and Bilateral Investment Treaties: A Comparative Review of the SGS Cases* (2004) 21:5 J. Int. Arb. 397; footnote 31.

18. This omission does not negate the possibility of binding arbitration or access to other international judicial procedures, such as the International Court or Justice, however, these procedures will necessarily be conditional on obtaining the consent of both State Parties.

19. Article 8(1) Russian Model BIT 2001.

20. See BITs concluded with: Cyprus (1997); Egypt (1997); Ethiopia (2000); Kazakhstan (1998); Lebanon (1997); Lithuania (1999); South Africa (1998); Thailand (2002); Turkey (1997) and Ukraine (1998).

21. "Foreign" awards are understood to be those that do not fall under the banner of domestic awards. (Article I(1) New York Convention). Depending on the domestic law of a State, an award may be considered "foreign" even where it has been rendered on the territory of the State concerned. For the definition of "international commercial arbitration" in Russia, see the Law on International Commercial Arbitration 1993.

22. See *e.g.* Yakolev, *International Commercial Arbitration Proceedings and Russian Courts,* 13:1 (1996) J. Int. Arb. 37; Hober, *Enforcing Foreign Arbitral Awards Against Russian Entities,* 10:1 (1994) Arb. Int. 17; Herbert Smith Publication, *Recognition and*

Enforcement of Foreign Arbitral Awards in Russia; Spiegelberger, *Russian Court Practice Enforcing Foreign Arbitral Awards: An Overview,* 22:4 J. Int. Arb. 351.

23. Only one arbitration interpreting a Russian BIT is in the public domain (*Sedelmayer v. The Russian Federation*, Stockholm Chamber of Commerce, Award of 7 July 1998).

24. See in particular *Sedelmayer v Russian Federation*, Award of 7 July 1998 (Stockholm Chamber of Commerce). The case arose under the Germany-Russia BIT and concerned allegations of expropriation of property. Also of note is the long-running Noga saga: the Murmansk State technical University Association Brest 2000 v. 1. Compagnie NOGA d'Importation et d'Exportation. Despite receiving an award in its favour in 1997 and in the face of repeated attempts to attach Russian owned property, the claimant has failed to successfully enforce its award.

25. At present, 46 States have signed and ratified the Convention: *www.coe.int/T/E/Com/About_Coe/Brochures/human_rights.asp*.

26. The Council of Europe has been strongly critical of the manner in which Russia has dealt with the Yukos affair, criticising, *inter alia*, the partiality of the judiciary, the manner in which trials have taken place and the conditions of detention in which the Yukos executives have been kept; Resolution 1418(2005) of the Parliamentary Assembly of the Council of Europe.

27. The Treaty itself contains a number of "soft law" undertakings and obligations incumbent on States, however, only alleged breaches of the obligations contained in Part III of the Treaty give rise to a direct right of action by investors (Article 26(1)). The protections in Part III include the principle of non-discrimination (national treatment), fair and equitable treatment, most constant protection and security, no unreasonable or discriminatory impairment, observance of obligations (Article 10(1)), MFN treatment (Article 10(3)) and prohibition of expropriation or measures tantamount to expropriation (Article 13). By contrast, not all issues have been resolved by the ECT, in particular with regard to transit across national borders.

28. See *Jilted Yukos shareholders turn to Energy charter Treaty arbitration,* Investment Law and Policy Weekly News Bulletin, November 18 2004.

29. *http://europa.eu.int/comm/external_relations/russia/intro/index.htm*.

30. See "Stocktaking of Developments in Investment Agreements: Preliminary Results"; DAF/INV/WD(2005)10.

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Chapter 6

Russia's Capital Control Reform

The 2004 Foreign Exchange Law represents a major improvement for domestic as well as foreign investors. Its general orientation towards progressive liberalisation, endorsement of the overarching principle of non discrimination and increased transparency are consistent with the guiding principles of the OECD Code of Liberalisation of Capital Movements. However, the new Law also introduced a very complex and elaborate system of controls imposable on a large number of capital account operations through the mandatory use of special accounts with attendant reserve requirements of varying rates and maturities. According to the views of market participants, this system has proved to be excessively burdensome and de facto restricted many operations linked to inward and outward capital flows.

A number of restrictive and cost ineffective capital control arrangements are being phased out on 1 July 2006, in advance of the schedule of 1 January 2007 initially foreseen by the 2004 Foreign Exchange Law. This should be accompanied by building the necessary institutional structures and capabilities to ensure an adequate statistical and reporting system for all categories of financial market activities of concern for authorities in charge of prudential safeguards, anti-money laundering and appropriate tax control. The most urgent issue would be to address the current weaknesses with respect to co-ordination of these important tasks amongst the relevant authorities. Continuing international monitoring is warranted given that the 2004 Law does not preclude the reinstatement of capital controls, in particular in the case of balance of payments difficulties.

1. The situation before the entry into force of the 2004 Foreign Exchange Law

Following the dissolution of the Soviet Union in 1991, a Foreign Exchange Law was introduced in 1992 and remained in force until replaced by the current Federal Law No. 173-FZ of December 13 2003 which entered into force on 18 June 2004 (hereafter "the 2004 Law").

The Russian Federation accepted the obligations of Article VIII of the IMF's Articles of Agreement with effect from June 1996, confirming the absence of foreign exchange restrictions on payments and transfers for current account transactions. The majority of capital account operations remained subject to licensing by the Central Bank of the Russian Federation (CBR), based on the 1992 Foreign Exchange Law as complemented by Presidential Decrees and the instructions and letters issued directly by the CBR.

Much of the amendments to the legislation and additions to the implementing regulation were developed in response to the persistent capital flight experienced in the 1990's, in particular in the aftermath of the 1998 financial crisis. Whether for motives of hiding profits from illegal activities, avoiding the reporting of income for fiscal reasons or simply seeking a safer financial haven, it has become an established fact that many private entities in Russia transfer resources abroad in contravention of existing exchange regulation. The channels for capital flight are well established and recognised, and include:

- underreporting of export earnings;
- overstatement of import payments (including false contracts);
- fictitious advance import payments; and
- a panoply of capital account transactions effected through correspondent accounts of non resident banks with Russian banks.

The efforts to stem this haemorrhage have been many and varied but rarely successful.[1] The capital flight problem, as perceived by the Russian authorities, thus substantially contributed to the complexity of foreign exchange regulations faced by private sector entities operating in the Russian business environment. The 1992 Federal Law and the multitude of implementing instructions and letters issued by the CBR during which the twelve year period the old law remained in force, produced a system of foreign exchange regulation

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which was onerous and often non-transparent for private sector businesses and individuals and extremely cumbersome to operate for the authorities.

Foreign as well as domestic market participants, in particular exporters and importers raised numerous complaints regarding the difficulties the old law presented to them in their normal business operations while international agencies and advisers repeatedly recommended to the Russian authorities that their foreign exchange regulation be simplified and modernised in line with accepted international practice. In 2001, the OECD Investment Committee recommended[2] making more transparent the system of licensing capital account operations and rendering the rules for non-resident accounts more systematic and user-friendly. It also suggested that the exchange control system for both current and capital account operations should be amended to permit market participants to make freely those payments and transfers which are required under contracts that have been legally entered into and cover transactions not prohibited by laws or regulations.

The Russian authorities were in no way impervious to the need for reform of the system for foreign exchange regulation and control. Work in this direction was in fact initiated as early as 1995. However, the 1998 financial crisis not only brought the reform work to a temporary halt but also engendered many differing views among policy-makers and experts regarding the form and extent of currency regulation and control that should be developed for the post-crisis Russian economy. During the years 2000-2003 a number of different law proposals were developed and hotly debated, with the Ministry of Economic Development and Trade as well as the relevant Duma Committees taking leading positions in arguing for as far-reaching liberalisation as possible. The need to drastically circumscribe the discretionary powers of the CBR in the sphere of currency regulation was also strongly put forward. The CBR, on the other hand argued for tightening the regulations governing the movement of capital, in particular by obtaining more tools for use during crises to limit capital outflow.

2. Main Provisions of the 2004 Foreign Exchange Law

The 2004 Foreign Exchange Law was adopted by the Duma as a compromise version between proponents of complete liberalisation and advocates of leaving the monetary authorities with sufficient tools to limit capital flight.

The 2004 Law embodies thoroughly revised foreign exchange legislation, drafted to align with OECD best practices by adopting the negative list principle approach in accordance with which all transactions except those separately singled out are to be considered free. In addition, it specifically excludes all unreasonable interference by the State and bodies thereof into currency transactions of residents and non-residents, emphasises the uniformity of the currency regulation and control system across the territory of the Russian Federation and requires that all acts of the Russian Federation currency legislation and of the regulatory bodies must be officially published in order to be valid (with exception of acts containing information and data failing under legislation on State secrets). It also establishes that all doubts, contradictions and ambiguities that may remain in these acts shall be interpreted in favour of residents and non-residents.

The law technically relies on:

- the concept of a Special Account, which is defined as:

  "a special account opened with an authorised bank or a special section of a depo account or a special section of a personal account opened by register holders in a register of owners of securities for registering rights to securities, which is used for making currency transactions on it in the instances established in compliance with the … (new 2004 Law)";
- a list of capital account operations set out in the 2004 Law (Articles 7, 8, and 11) requiring mandatory channelling through special accounts;
- instructions for the use of these special accounts issued by the Central Bank of Russia (CBR), providing details of the types of special accounts to be opened by authorised banks for residents (F, R1, R2) and non-residents (S, A, O, V1 and V2) and the circumstances in which these accounts must be used. The CBR Instruction of 7 June 2004 N. 116 establishes that professional securities market participants such as brokers/dealers and registrars must open parallel custodial/deposit accounts in respect of transactions for residents and non-residents with domestic and foreign securities;
- directions issued by the CBR from time to time, establishing which operations on special accounts are currently subject to unremunerated reserve requirements as well as the percentages and maturities of the latter.[3]

A remaining deviation from what could be considered best international practices is that there are no clear definition provided of what constitutes current and capital account operations, apparently due to the fact that this was not considered necessary once a negative list existed, clearly setting out those capital account operations under restrictions. The fact that a surrender requirement for export earnings is still present, in addition to the repatriation requirements, could likewise be considered as contradictory to "best practice", as well as out of line with other measures of reform of the currency regulation embodied in the 2004 Law.

The stated aim of the 2004 Law is to "… ensure the pursuance of a uniform State monetary policy as well as the stability of the domestic currency and the steady state of the Russian currency market ..." Not explicitly stated but clearly

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the aim of the system of mandatory special accounts *cum* reserve requirements is to provide the CBR with necessary tools to monitor and control the categories of capital flows that are likely to prove volatile in face of disturbance affect ting the domestic financial markets.

The 2004 Law is divided into five chapters, of which the first and the last contain *General Provisions* and *Final Provisions*, respectively, while Chapter 2 deal with *Currency Regulations*, Chapter 3 with *Repatriation of Foreign and Domestic Currency by Residents* and *Obligatory Sale of ForeignCurrency Receipts* and Chapter 4 with *Currency Control*. A summary of their content is provided below.

2.1. General and final provisions

The provisions in the first chapter include a number of definitions and are basically self-contained, with the only explicit reference to other laws relating to the concept of "securities" where the definitions provided in the Civil Code are referenced. There are no cross-references to the securities legislation currently in force in the Russian Federation, despite the fact that this legislation contains provisions which, under the OECD Code of Liberalisation of Capital Movements, are considered as direct restrictions on the issue of securities abroad by residents, as well as on the issue of securities in the Russian Federation by non-residents.

Definitions of residents and non-residents follow standard international practice, *e.g.* including as residents Russian branches, representative offices and other subdivisions of residents situated abroad and *vice versa* excluding from the definition of residents branches, representative offices etc. of foreign residents situated in the Russian Federation. The definition of authorised banks is likewise standard and includes foreign banks duly licensed by the CBR to transact in foreign currency.

To accommodate the currency regulation and control system set out in the subsequent chapters, the General Provisions introduce the concept of a *Special Account*, which is defined as: "A special account opened with an authorised bank or a special section of a depo account or a special section of a personal account opened by register holders in a register of owners of securities for registering rights to securities, which is used for making currency transactions on it in the instances established in compliance with the (new law)". This provision has an explicit sunset clause, giving as expiry date 1 January 2007.

The instructions for the use of these special accounts were issued in CBR Instructions of 7 June 2004 N. 116-(as amended by the Direction U 1529 of the CBR issued 16 December 2004) and provides details of the types of special accounts to be opened by authorised banks for residents (F, R1, R2) and non-residents (S, A, O, V1 and V2). This Instruction also sets out the circumstances in which these accounts must be used while CBR Instruction of 7 June 2004 N. 115-I establishes that professional securities market participants such as broker/dealers and registrars must open parallel custodial/deposit accounts (S, A and O for their non-resident clients (see Annex 6.A1 for a summary of the requirements for the use of special accounts by residents and non-residents).

The Final Provisions set out details regarding the entry into force of the New Law and its separate provisions, formally invalidate previous legislation and regulation and recapitulate (in Article 26 part 3) all articles or parts thereof subject to the sunset clause. They finally explain the procedure for adjusting current permits and licenses for capital account operations issued under the old law to the new regulatory situation.

2.2. Currency Regulations

This chapter of the Law establishes that the bodies carrying out currency regulation in the Russian Federation are the CBR and the RF Government, through the issuance of acts that shall be binding for residents and non-residents.

It is clearly stated in Article 5 part 3 that no individual permits or authorisations shall apply (this regulation entered into force on 18 June 2005 with an enforcement date of 19 June 2005 in order to accommodate the requirement that individual permits for residents/juridical persons to open accounts with banks abroad was still operative in accordance with the process defined under the old law until that date). Preliminary registration (with the tax administration in the place of registration of the resident) shall be imposed only on the opening of accounts with banks abroad elsewhere than in OECD and/or Financial Action Task Force (FATF) member countries (for physical persons from 18 June 2004 and juridical persons from 19 June 2005) and import and export of currency and securities in a documentary form.

Article 6 of this chapter plays the crucial role of trigger for the "negative list", giving the reference to capital account operations listed in subsequent articles in respect of which restrictions may be established for purposes of preventing reserve losses and for sustaining balance-of-payment stability. It states that the restrictions shall be non-discriminatory in nature and shall be lifted when "the circumstances causing their establishment are eliminated". It thus also serves as the standard derogation clause for situations of general economic and financial disturbance which may justify the imposition of restrictions.[4]

The actual enumeration of the restricted operations is set out in Articles 7, 8 and 11 which are all wholly or in part subject to the "sunset" date of 1 January 2007. From that date, in accordance with part 3 of Article 26 of the 2004 Law, the currency control authorities will no longer have a basis for imposing

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requirements regarding opening of special accounts, unremunerated reserves on such accounts or mandatory surrender of foreign exchange earnings.

Article 7 contains the list of medium and short term trade-related settlements and transfers regulated by the RF Government. These cover import and export-related trade credits (including export payments delays and import payments advances) for terms in excess of three years for a specific list of commodities (five years in the case of construction contracts), and over 180 days for other trade credits. The reserve requirements to be imposed on these trade-linked credits cannot exceed 50 per cent of the amount concerned, nor be required to be kept on the account for more than two years.

The capital account operations where the CBR has the authority to impose restrictions are set out in Article 8, which clearly establishes that such restrictions can *only* take the form of requirements to conduct operations through special accounts and requirements to make reserves on such accounts to be held on an unremunerated basis at the CBR. It further provides the reference to the implementing regulation where the types and manner of operation of these special accounts is provided (Instruction of the CBR No 116-1 of 7 June 2004 – see Annex 6.A1).[5]

For *residents*, such restrictions can be imposed on the following categories of capital account operations:[6]

- foreign currency credits and loans granted by residents to non-residents and by non-residents to residents;
- transactions in foreign securities;
- transactions by credit organisations, excepting those undertaken by authorised banks.

For *non-residents* the requirement to use a special reserve account may be established for:

- rouble credits and loans granted by residents to non-residents and by non-residents to residents;
- transactions in foreign securities;
- transactions in domestic securities.

The maximum percentages and terms for the unremunerated reserve requirements allowed to be imposed for these various categories of operations are either 100 per cent for sixty days or 20 per cent for one year, depending on the exact nature of the operation, for residents as well as non-residents. The reserve requirements are symmetrical for residents and non-residents and no duplication or accumulation affecting the same operation is allowed. The actual rates applicable from time to time will be set by the CBR in consultation with the RF Government (see Appendix I for details regarding the reserve requirements currently imposed which are effectively limited to transactions in foreign and domestic securities).

Article 9 establishes that foreign currency operations between residents are prohibited except for those between brokers, agents, lawyers servicing foreign contracts, transactions between authorised banks and between authorised banks and their clients. In respect to the latter, banks have raised complaints through their professional association that the list of authorised operations with residents in foreign currency contained in Article 9 part 3 is considerably shorter than that existing under the 1992 Foreign Exchange Law and thus implies a real curtailment of business activity.[7]

Article 10 establishes that non-residents may freely transfer foreign currency from bank accounts abroad to accounts with domestic banks. They may also transact freely in foreign currency in the Russian Federation subject to using accounts at authorised banks. Transactions in domestic securities between non-residents must follow the procedure set by the CBR which may provide for the use of special accounts (although this is not the case at present).

Article 11 deals with the rules for the operation of the domestic foreign currency market in the Russian Federation and provides references to all the implementing regulation and procedure in force for authorised banks for dealing in foreign currency, including updated identification of client requirements.

For sale and purchase of foreign currency and cheques, the CBR may establish the need for use of special accounts by residents and non-residents as well as the requirement to make a reserve equivalent to 100 per cent of the sum concerned for sixty days at most for residents and for 20 per cent of the sum for a maximum period of one year for non-residents. Only one of these two types of reserve requirements may be imposed on one and the same transaction and none of them shall apply to currency sale and purchase in connection with transactions already subject to reserve requirements under the present law.

Article 12, which entered into force for physical persons on 18 June 2004 and for resident-juridical persons on 19 June 2005, deals with the opening of accounts with banks abroad by residents and stipulates that such accounts may be freely opened in foreign currency with any bank situated in foreign states which are members of the OECD or the FATF. Until that date, resident legal entities were obliged to obtain approval from the CBR for the opening of accounts abroad, under the procedure established under the old law.

As from 18 June 2004 for resident physical persons and from 19 June 2005 for juridical persons, can open without restrictions the accounts at the banks situated in member countries of the OECD and/or the FATF and are required to notify the tax bodies at the place of their registration of the opening or closing of such accounts within a period of one month of the actual date of opening (closing). Residents are required to register in advance with their local tax authorities the account to be opened at a bank abroad if such bank is located outside member countries of the OECD and/or the FATF. Transfers to such accounts may be subject to reserve requirements of a maximum of 100 per cent of the amount involved for a maximum period of sixty days. This requirement does not apply to authorised banks and currency exchanges.

As for non-residents, they are free to transfer funds between bank accounts abroad and accounts with authorised domestic banks as long as the latter have been opened following due procedure. However, the operations involving non-residents' special accounts, established for transactions with domestic securities or otherwise, may be subject to a reserve requirement of up to 100 per cent for a maximum period of sixty days if a transfer is made to a resident's account or 20 per cent for a maximum period of one year if funds are deposited on a non-resident's account. Both requirements cannot apply simultaneously to the same transaction.

Similarly, operations with the funds from residents' special accounts may be subject to reserve requirements of 100 per cent of the sum involved for a maximum period of sixty calendar days in the case of a withdrawal or 20 per cent for a maximum period of one year if funds are deposited on a resident's special account. Both requirements cannot apply simultaneously to the same transaction. These provisions are subject to the sunset clause.

Professional traders as well as authorised banks carrying out transactions for non-residents on the securities markets must open special discretionary accounts for recording non-residents' monetary funds. In the case of authorised banks, the CBR may require that they deposit (in whole or in part) equivalent amounts to the balance of funds in these accounts on correspondent accounts with the CBR.

Article 15 deals with the import and export of currency values, domestic currency and domestic securities. Resident and non-resident natural persons are entitled to export at one time from the Russian Federation the amount in cash not exceeding the equivalent of US$10 000, subject to declaration of amounts in excess of US$3000 to the customs authorities. For amounts in excess of US$10 000 it is necessary to comply with the customs requirement that evidence be produced to the effect that the amount had been previously imported into the country. In other circumstances, the export is not allowable.

Articles 16 and 17 set out the procedures for depositing the obligatory reserves on the special accounts as well as the categories of assets that may be used to discharge these obligations. Article 18 provides full details of the procedure and documentation required for preliminary registration of accounts opened by residents with banks abroad, including procedure for registration with tax bodies at the resident's place of registration.

2.3. Repatriation of foreign currency and the RF currency by residents and obligatory sale of part of currency receipts

The repatriation requirement for export earnings in foreign currency as well as domestic currency set out in Articles 19 of this chapter is not subject to the sunset date of 1 January 2007. It has a number of exceptions where residents are not obliged to repatriate funds onto domestic bank accounts, *e.g.* in the case of the servicing of loan contracts in foreign currency with residents of OECD or FATF member countries for terms exceeding two years and when receiving reimbursements for local outlays for construction projects carried out abroad.

Article 20 provides information regarding the *Transaction Passports* that the CBR requires residents to draw up with authorised banks to ensure the proper recording of and reporting of currency transactions between residents and non-residents. Such transaction passports have already been in use for a number of years for all imported goods and services (except those paid for with roubles from CIS countries). They are issued by authorised banks and provide details of the related financial transactions, primarily to enable control agents to combat capital flights through false or inflated import contracts.

The surrender requirement is detailed in Article 21, which is due to expire on 1 January 2007. Having earlier ranged from 75 to 25 per cent, the portion of residents' foreign exchange receipts subject to obligatory sale has been set at a maximum level of 30 per cent. The percentage of 10 per cent established by CBR Direction N. 1520-U of 26 November 2004 was lifted as of 1 May 2006. The foreign exchange receipts of authorised banks arising from lawfully conducted banking operations are not subject to the surrender requirement.

The exceptions for servicing of loan contracts entered into with residents of OECD and FATF member countries applies here as well as with respect to the repatriation requirement.

The obligatory sale of part of residents' foreign currency receipts shall be processed at the current rouble exchange rate formed on the domestic currency market in the Russian Federation as of the date of sale. In practice, it can be effected either directly to an authorised bank, or through an authorised bank at currency exchanges, an off-exchange market or the CBR. The list of the foreign currencies subject to the obligatory sale is determined and published by the CBR.

2.4. Currency control

This chapter of the law establishes that the overall responsibility for currency control lies with the Government of the Russian Federation and the currency control bodies and agents in compliance with the New Law and other Federal Laws. The control bodies are the CBR and the federal executive body designated by the RF Government, which, under its Decision 278 issued 15 June 2004 is the Federal Service of Fiscal Supervision.

Currency control agents are, as before, the authorised banks, under the supervision of the CBR, which as before oversees currency operations in the banking sector and the securities markets and determines procedures for the circulation of and operations with foreign currency and securities within the Russian Federation for residents and non-residents.

However, a novelty in the 2004 Law is that, as stated in Article 22 part 3, professional traders on the securities markets which are not authorised banks as well as registrars accountable to the Federal Financial Markets Service are also designated as currency control agents, together with customs agencies.

The RF Government is to ensure co-ordination between the federal executive bodies and the CBR in the exercise of currency control activities, and in particular ensure the interaction of professional traders on the securities markets in this respect with the CBR.

3. Suggestions for improvement to the implementing regulation from banks and securities market intermediaries

3.1. Comments made by the Association of Russian Banks

The Association of Russian Banks (ARB) has, on behalf of its members, made a number of approaches to the authorities currently engaged in reviewing the implementing regulations of the new foreign exchange law, in particular the departments of financial policy and of regulation of government financial control within the Ministry of Finance. The ARB communications, which have been made available to the OECD Secretariat, contain a large number of suggested amendments to the regulations currently in force, in particular with respect to the list of permitted operations in foreign currency between residents as well as between residents and authorised banks (see Article 9 of the 2004 Law and its implementing regulations). The Russian commercial banks observed that the New Law could reduce their scope for commercial transactions with residents in foreign currency compared to the situation under the old law and thus leaving them at a competitive disadvantage *vis-à-vis* foreign banks.

As to the operation of the new system of special accounts, the banks find that it has caused considerable upheaval to long-established routines under the old system. They point to the suddenness of its introduction, without due advance preparation, as well as its costliness.[8] Some confusion apparently still reigns regarding certain reporting procedures although banks have long experience in acting as control agents for the currency control bodies.

3.2. Comments made by foreign-owned Banks and securities firms[9]

Representatives of foreign-controlled financial institutions operating in Russia acknowledge the overall improvement brought by the realignment of the new foreign exchange legislation with recognised international best practice. In particular, they appreciate the following specific positive changes brought by the new regulations:

- terms for export/import settlements increased from 90 to 180 days;
- exemption from surrender requirement for servicing debt under foreign loans obtained from OECD, FATF residents with maturities above 2 years;
- Russian individuals may invest into foreign securities up to $150.000;
- liberalized procedure for purchase of foreign currency and taking cash abroad for individuals;
- limitations on settlements for real estate have been removed.

At the same time, they pointed to the following specific disadvantages for foreign as well as Russian banks:

- surrender requirement does not allow Russian exporter to effect assignment of export proceeds in favor of Russian bank – lender (exemption exists only for foreign loans from OECD, FATF countries);
- limitation of foreign currency payments between residents significantly complicates accounting schemes used by Russian banks for settlements of transactions with foreign securities;
- lack of legislation regulating domestic transactions with derivatives and risk of imposition of compulsory reserve requirement in case of sale/ purchase of foreign currency undermine development of this market.
- limitations imposed on settlements of transactions with domestic securities between a Russian bank and a non-resident customer result in decrease of these operations, when a Russian bank acts as a broker.
- requirement for compulsory unremunerated deposits, which applies to rouble loans granted by Russian banks in favor of non-resident clients makes this product unattractive for clients;

Regarding the right to open accounts with banks located abroad which was granted to Russian juridical persons as of 19.06. 2005 (one year after the entry into force of the New Law), it was emphasized that banks located in Russia will not execute transfer to such an account without documentary proof by the customer that he has registered the said account with tax inspectorate. Relevant procedures were established by the Directive of the Federal Government N. 623 of 17 October 2005.

As to the operations with special accounts, the following comments were made. In their capacity as currency control agents, banks are responsible for proper execution of these functions and may face penalties in the amount of transaction processed. At the same time the New Law stipulates that banks are liable for misuse of powers in the conduct of currency control and for abusing client's rights by fulfilling these functions. This creates an ambiguous situation for a bank in circumstances of unclear instructions or lack of legislation. Banks may face penalties for non-compliance with the duty to reply to numerous requests from customs, tax and other authorities in terms of observing established deadlines and correctness and completeness of the information provided.

In summary, the banking community finds that the implementing regulations to the New Law have brought a considerable rise in risks associated with processing of foreign currency settlements for customers. Other negative consequences are growth in paperwork for the bank and for the customer as well as an increase in processing costs for banks. The banking community proposed that the following improvements be made to the regulations in force:

- unification of information flows between currency control authorities and banks in order to improve monitoring, control and analysis functions;
- standardization of procedures for control applicable to different types of currency transactions;
- delegation of major control functions over foreign trade transactions to customs authorities;
- banks should concentrate on anti-money laundering procedures and further implement those procedures into practice.

3.3. Comments made by securities markets intermediaries

An exchange of communications between the National Association of Securities Dealers (Naufor) and the CBR during the summer and early autumn of 2004[10] gives an illustration of the problems encountered by securities market professionals when first confronted with the implementing regulations developed by the CBR during spring and early summer 2004. As most of these were resolved during subsequent months by the CBR through clarification and adjustment measures, only a brief listing of these initial difficulties is provided below. Still, even if later resolved the fact that the problems persisted for several months and were considered detrimental to market activity by Naufor should serve as an indication that additional prior consultations might have been advisable.

The following main points were raised by Naufor:

- lack of clarity in the specification of new functions to be performed by securities market professional firms in their role as control agents;
- loss of business and goodwill from foreign clients due to onerous nature of new regulations, which in turn has impacted negatively on market development;
- conflicting instructions between market regulator the Federal Financial Markets Service (FFMS) and the CBR;
- the new implementing regulation affecting securities market operations does not align with the expressed liberalisation objective set for the overall reform of the foreign exchange regulation;
- the requirement for use of special accounts potentially causes conflict with the provision in the Civil Code regarding the freedom to conclude contracts (Articles 158 and 160 of the Civil Code of the Russian Federation);
- should transactions in derivatives, such as futures, options and forwards which are not "securities" in the true sense, also to be included amongst the securities operations which according to the New Law must be handled through special accounts?

Additional issues raised in the Naufor communications concerned details of the allowable transfers of funds from the special accounts to other accounts, whether bills of exchange denominated in foreign currency but payable in roubles (in accordance with the Geneva convention on Bills of Exchange) by non-residents should be considered foreign securities and how depositaries can determine whether a foreign currency operation is concerned if both parties to a deal do not have their accounts with this particular depositary. Further problems were related to the duties foreseen in the implementing regulation for both registrars and depositaries in circumstances which Naufor illustrated with a number of concrete examples.

The responses addressed to Naufor by the CBR clarified matters in many respects and, according to the CBR, most of the problems have been resolved by subsequent implementing regulations and instructions.

4. Assessment of the 2004 Law and its implementing regulations against the liberalisation provisions of the OECD capital movements code

The Russian Federation has on several occasions expressed its intention to increase the consistency of its laws and regulations with OECD standards. This section provides a preliminary assessment of the current Russian foreign exchange regime against the liberalisation provisions of the OECD Code of Liberalisation of Capital Movements.

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The *OECD Code of Liberalisation of Capital Movements (hereafter the Code*) reflects member countries' recognition of the long-term benefits of open markets and their commitment to progressive liberalisation of capital account operations between residents and non-residents. It has served as a guiding framework for OECD Members for over forty years in their approach to capital account liberalisation. While most older OECD Members had reached a state of near complete liberalisation of their capital accounts already in the 1980's, the Code has lately played an important role in the liberalisation process of new Members acceding to the Organisation. In particular the experience of the Czech Republic, Hungary, Poland and Slovakia as former transition countries in opening their capital account through the acceptance of the liberalisation obligations of the Code has produced experience of relevance for the Russian Federation. Experience from the accession and subsequent post accession reviews of these four countries within the OECD peer review process has in fact been made available to the Russian authorities in the past few years.[11]

The general orientation towards progressive liberalisation and the endorsement of the fundamental principle of non-discrimination contained in Russia's new foreign exchange law described above brings the Russian position closer to the guiding principles of the Code. The concept that sub-national entities such as states, provinces, regions and autonomous units should not impose foreign exchange restrictions under regional authority also conforms to OECD Members' practice under the Code. In addition, the level of transparency has increased greatly, in the sense that there is now a uniform body of law with clearly defined objectives and guidelines, containing all the relevant information (or clear references thereto in the case of implementing regulation) necessary to assess the complete regulatory environment relevant to foreign exchange transactions. Transparency has also been increased through the clear limitations set for the discretionary authority of the CBR and the reinforced requirement that all relevant acts be officially published.

Through the entry into force of the New Law, the Russian authorities removed a number of direct restrictions previously affecting virtually all capital movements other than FDI under the old law, in the form of compulsory licensing or prior authorisation requirements. In addition, through their removal, the scope for discretionary abuses through rent-seeking practices on the part of individual officials in charge of currency control has been greatly reduced, thus significantly improving the business environment.

However, where enforced, the imposition of compulsory reserve requirements provided for in the New Law is considered a restriction under the Code. In addition, although not all of these reserve requirements are enforced on the operations to which they apply at the present time and despite the fact that their removal is scheduled for 1 January 2007, the 2004 Law has, through the requirements of channelling operations through special accounts, in effect brought in a complex and – according to the views of market participants reflected in section 3.2. – excessively burdensome system of regulation which in their view restricts many operations linked to inward and outward capital flows. This conflicts with an important principle in the Code which provides that the underlying transactions themselves should not be frustrated by restrictive regulations affecting transfers and payments.

The number of actual operations required to be conducted through special accounts under the New Law and which may thus be subject to reserve requirements of varying size and maturity, is quite large. In fact, looking at the list in the Code of capital account operations subject to the progressive liberalisation obligation, the conclusion must be that most of them would be concerned by the provisions in articles 7, 8, 9 and 11 in the 2004 Law. In addition, the repatriation requirement in Articles 19 would also be categorised as a restriction under the Code, in this case of residents' right to sale of foreign currency abroad. According to published IMF Staff Reports, Russia also still maintains restrictions which are contrary to its obligations under Article VIII, Sections 2, 3 and 4 under the Fund's Articles of Agreement and which, subject to further scrutiny, may not conform with the Code's provisions as well.

It would appear at first view that the reserve requirements imposable on residents and non-residents regarding capital inflows and outflows would call for notional "reservations" to the following Items in the Code of Liberalisation of Capital Movements:

List A:

IV. Operations in Securities on Capital Markets.

VII. Operations in collective investment securities.

VIII. Credits directly linked with international commercial transactions or with the rendering of international services (in cases where a resident participates in the underlying commercial or service transaction).

X. Sureties guarantees and financial back-up facilities (in cases directly related to international trade or international current invisible operations, or in cases related to international capital movement operations in which a resident participates).

XI. Operation of deposit accounts (operations by non-residents of accounts with resident institutions).

List B:

V. Operations on Money Markets.

VI. Other Operations in negotiable instruments and non-securitised claims.

VIII. Credits directly linked with international commercial transactions or with the rendering of international services (in cases where no resident participates in the underlying commercial or service transaction).

IX. Financial credits and loans.

X. Sureties guarantees and financial back-up facilities (in cases not directly related to international trade or international current invisible operations or international capital movement operations or where no resident participates in the underlying international operation concerned).

XI. Operation of deposit accounts (operations by residents of accounts with non-resident institutions).

XII. Operations in foreign exchange.

5. Overall assessment and way forward

5.1. Achievements and shortcomings of the 2004 Foreign Exchange Law

The analysis of the 2004 Law and the reactions of market practitioners show that the 2004 Foreign Exchange Law has brought several important achievements, in particular:

- the general orientation of the law towards progressive liberalisation and its endorsement of the overarching principle of non-discrimination that are consistent with the guiding principles of the OECD Code of Liberalisation of Capital Movements;
- the concept that sub-national entities such as states, provinces, regions and autonomous units should not impose foreign exchange restrictions under regional authority conforms to OECD Members' practice;
- it has raised the level of transparency through the fact that there is now a uniform body of law with clearly defined objectives and guidelines, containing all the relevant information (or clear references thereto in the case of implementing regulation) necessary to assess the complete regulatory environment relevant to foreign exchange transactions;
- it sets clear limitations for the discretionary authority of the CBR, thereby contributing to minimising rent-seeking opportunities for individual currency control officials throughout the territory of the Federation, and reinforces the requirement that all relevant acts be officially published.

However, the 2004 Law also introduced a very complex and elaborate system of controls to be imposed on a large number of capital account operations through the mandatory use of special accounts with attendant reserve requirements. The criteria on the basis of which the operations subject to reserve requirements have been selected were not fully clarified and did not seem to reflect for instance maturity-related considerations, except in the case of financial credits (see Annex 6.A1).

The compulsory reserve requirements provided for in the 2004 Law would be considered restrictions under the Code in respect to the categories of capital operations to which they are effectively enforced. In addition, even though not all of these reserve requirements are enforced on the operations to which they apply in theory, the 2004 Law has, through the requirements of channelling operations through special accounts, brought in a complex and – according to the views of market participants – excessively burdensome system of regulation which *de facto* restricts many operations linked to inward and outward capital flows. This is in conflict with an important principle in the Code which provides that permitted underlying transactions themselves should not be frustrated by restrictive arrangements and regulations linked to transfers and payments.

The 2004 Law set a cut-off dat for these controls as early as 1 January 2007. In fact, the Russian authorities recently announced that some important steps in capital control reform will already be undertaken on 1 July 2006, in advance of the initial schedule. In particular, reserve requirements related to capital control account transactions should be eliminated and the requirement for obligatory use of special accounts abolished. There is nothing, however, in the 2004 Law that precludes the reinstatement of an identical or similar system of controls on any other date. The control system aims to provide the CBR with the necessary tools to monitor and control the categories of capital flows that the authorities consider to be particularly volatile in face of disturbances affecting the domestic financial markets. Its effectiveness in this respect remains somewhat in doubt since the implementation of the complete system is not fully co-ordinated amongst the authorities involved.

Given recent liberalisation steps, it is becoming increasingly urgent for the authorities to develop functional alternative systems of recording and monitoring of flows for statistical, tax and other legitimate purposes to enable them to confront and maximise the benefits of full liberalisation with more appropriate and market-friendly safeguards in place.

At the present time, the CBR has not developed any such safeguards. Their stated view is that the registration and reporting system relying on balance-of-payments statistics, customs and bank data already in place before the revision of the legislation in 2003 will continue to provide adequate monitoring tools. However, they do admit that the information received on capital account transactions – in particular transactions with securities – is incomplete even with the new special account regulation in operation. Detailed instructions for the recording of securities transactions on the special accounts by market professionals acting as control agents in addition to authorised banks were never fully elaborated by the Federal Financial Markets Service due to strong resistance from major securities broker-dealer firms. In addition, as a general point, the sharing of the information gathered by different supervisory authorities in not fully provided for, neither in the legal sense, nor in actual practice. It is therefore essential to improve information sharing among financial markets regulatory bodies in Russia.

5.2. Policy options after January 2007

Judging from the complexity of the system of mandatory special accounts with attendant unremunerated reserve requirements and its extremely voluminous implementing regulation, complete elimination appears difficult. Indeed, consultation by the OECD Secretariat suggested that doing away with the current system of mandatory special accounts without any alternative control apparatus[12] in its place will be difficult to accept for those official agencies who put their views and expertise into the drafting of the complex subsidiary legislation to the 2004 Law required to support the present elaborated scheme of controls. It would also seem unacceptable to those policy makers and experts who continue to voice serious concerns about a possible resulting increase in flows related to criminal activities of different kinds, unless appropriate other safeguards are made effective.

As stated above, the existing recording and monitoring systems for financial market activities and associated capital flows do not provide the authorities with the full and timely insight into current and potential developments which would be desirable for prudential, anti-money laundering and legitimate financial sector stability concerns.

On these grounds the proposed recommendation is to phase out the current restrictive and cost-ineffective capital control arrangements as foreseen by the New Law and, as a matter of priority, to structure and co-ordinate amongst relevant authorities the necessary statistical reporting, appropriate tax control, anti-money laundering and other prudential safeguards as well as build corresponding institutional capacities. This would also entail developing and reinforcing the bilateral and multilateral co-operation between the Russia's financial regulator and its anti-money laundering authority with parallel institutions in foreign financial centres. There is particular urgency for the Federal Financial Market Service to obtain the enactment of a number of proposed amendments to the Law on the Securities Markets which would enable it to partake in on-going networks of cooperation amongst foreign regulators on a bilateral and multilateral basis.

The Russian financial market environment is not yet sufficiently mature for a fine-tuned, less heavy-handed signalling of intentions such as applied by monetary authorities operating in highly developed financial centres. There appears still a lack of mutual confidence and constructive co-operation between professional market participants and regulatory authorities. Moreover, the transparency of securities regulation as well as the demarcation and co-ordination of functions in this respect between different authorities still needs to be improved. The lack of co-operation and co-ordination amongst different bodies and departments which is symptomatic for the entire Russian government structure is particularly detrimental to financial market regulation and supervision, where a unified policy stance and coordinated signals are absolutely indispensable**.** Given this institutional weakness and the serious turbulences experienced by the market over the past decade, it is crucially important that financial market regulators gain more trust and credibility in the eyes of professional market participants through the conduct of an open and co-operative public-private sector dialogue for the further development of foreign exchange regulations.

The financial market regulator is well aware of the drawbacks of the current system of institution-based as opposed to more effective functional supervision and has elaborated a comprehensive proposal to the government for the establishment of a unified regulatory and supervisory authority which would operate as an independent entity, including with respect to funding. No concrete steps have as yet been taken in this direction.

5.3. Comments by the Central Bank of Russia

In responding to several questions by the OECD Investment Division in November 2005 in Moscow, Mr Korishenko, First Deputy Chairman of the CBR together with other members of CBR presented the point of view of the Central Bank. Mr. Korishenko pointed to the main objectives set for the 2004 Law, namely to limit the impact on the domestic economy of short-term capital flows and to protect the banking sector from a major haemorrhage of its domestic deposit base. Overall, the model adopted for the control system was an "inflow-outflow" type. As to the individual operations selected, CBR experts had followed the traditional classification of financial market instruments and categories of operations; *i.e.* operations with shares, obligations, money market instruments, credit market operations (excluding operations with government debt instruments which are subject to special regulation in view of their importance and the large volumes traded). Reserve requirements had been imposed on some of those operations that are deemed to be potentially volatile, more as a "warning signal" with amount and durations far from prohibitive levels.

Overall, the CBR states that the imposition of requirements for unremunerated deposits in special accounts is fully in line with the intentions of the 2004 Law to move away from administrative restrictions towards market-based measures of control.

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Regarding the effectiveness of the reserve requirements imposed in deflecting unwanted inflows, the CBR is of the view that market participants certainly are sensitive to the costs involved in making the unremunerated reserves but admit that the effect is not very noticeable at the fairly low level where they are currently set. However, evidence with respect to the special regulations regarding foreign participation in the government bond market where barriers are higher in terms of percentages and duration of deposits required is more conclusive on this point.

As regards cost-effectiveness, the CBR maintains that through the move from case-by case authorisation-based regulation to overall market-based regulation by type of transaction, cost effectiveness is automatically greater.

Regarding the reduced attractiveness of the Russian market for foreign investors, the CBR points out that the very intention with the reserve requirements was exactly that – to make operations in the Russian securities markets less attractive to foreign operators. This applies especially to efforts directed towards smoothing out in time very large short-term cross-border capital flows, which can have significantly more negative impact on the market and the economy than a medium-term reduction in the attractiveness of Russian financial market instruments. As to the effect on competition it was pointed out that the one year delay following the entry into force of the 2004 Law in freeing up the opening of accounts in banks abroad by Russian juridical persons was intended to protect the competitive position of Russian banks.

Regarding monitoring post 2006 when the provisions in the 2004 Law on Special Accounts and reserve requirements will be gone, the CBR points out that they will still conserve requirements regarding prior registration and the use of certain special accounts. Furthermore, Article 19 of the 2004 Law setting out the repatriation requirement and Article 9 setting out procedures for currency operations between residents as well as procedures for residents to operate deposit accounts and to open accounts with banks located abroad (Article 12) will remain.

Most fundamentally, the CBR points out that the existing mechanisms of the system of reporting currency operations will remain in place, being basically reliant upon balance-of-payments statistics as well as data from the customs offices complemented by reporting from the banks and other currency control agents.

Notes

1. Many estimates of capital flight exist but even on the modest basis of equating it to part of the net errors and omissions item on the balance of payments an average level of US$11 billion per annum was recorded during 1994 –1999. More comprehensive estimates covering later years point to annual levels above US$20 billion.
2. *The Investment Environment in the Russian Federation*, OECD 2001, page 16.
3. See Annex 6.A1 for a summary of the requirements for the use of special accounts by residents and non-residents.
4. There is no expiry date to this article, which means that, technically, the current "negative list" of restricted operations (which is subject to the sunset clause) could be quite simply replaced by an amended list as of 1 January 2007, although the CBR has stated that this is not the intention at the present time.
5. The types of operations currently subject to reserve requirements and the level of reserves currently required are set up in CBR Direction N. 1465-U of 29 June 2004 as amended by the CBR Direction N. 1540-U of 29 December 2004.
6. Due to lack of clear distinction in the Law as to what represents capital account operations as distinct from current account operations, some operations mentioned in this Article can actually be interpreted as current account operations, although the CBR is bound by Article VIII of the IMF Articles of Agreement not to impose any restrictions on payments and transfers for current account operations.
7. The list of authorised operations was widened – see the Federal law N. 90-FZ of 18 July 2005 on "Introductions of changes in some legal acts of the Russian Federation".
8. Authorised banks were informed about the provisions of the implementing regulations to the new law only in June 2004, on the eve of the entry into force of the law on 18 June 2004.
9. These comments were made at a meeting on 11 October 2005 organised by the Association of European Businesses in the Russian Federation on the subject of currency regulation and currency control at which an earlier draft of the present report was discussed.
10. This exchange of communications has been made available to the OECD Secretariat.
11. See *Forty Years of Experience with the OECD Code of Liberalisation of Capital Movements,* OECD 2002.
12. The 2004 Law confirms the procedures for mandatory registration, documentation and reporting of operations necessary for monitoring purposes, which existed already in the Old Law. These would in any case remain beyond the 1 January 2007 cut-off date for the special accounts requirements.

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ANNEX 6.A1

Summarised Provisions Regarding Special Accounts with Banks

Summarised provisions regarding special accounts set out in CBR instructions No. 116-I of 7 June 2004 as amended by CBR direction No. 1529 U of 16 December 2004 and current level of reserve requirements imposed as set out in CBR direction No. 1465-U of 29 June 2004 and amended 29 December 2004

The Special Accounts referred to in the General Provisions of the New Law which are to be used for the list of restricted transaction provided in Article 8 of the New Law (see section 3.1) are either *special bank accounts* to be opened by authorised banks for residents and non-residents or *special sections of custodial accounts* to be opened by resident professional participants in the securities market for residents and non-residents.

Both the special accounts with banks and the special sections of custodial accounts to be opened for *residents* are referred to as type F, type R1 or type R2. Those to be opened for *non-residents* are categorised as type S, type A, type O, type V1 or type V2 in the case of special bank accounts. For special sections of custodial accounts for non-residents, type S, A and O exist and there are also special sections of non-residents personal accounts in share registers to be opened by registrars referred to as type A.

The uses of these various categories of accounts are the following:

For residents

On special bank account type F opened for *residents who are natural persons* should be recorded in-and outflows of foreign currency in connection with credits and loans to non-residents by residents and also the obtention of credits and loans from non-residents for a term of less than three years as well as in-and outflows in connection with acquisition or sale of foreign securities.

The special section of a custodial account type F serves to provide a record of a resident's (natural person's) holding of foreign securities and its entries should thus mirror the acquisitions or sale for which the monetary flows are recorded on the special bank account type F. No reserve requirements are currently enforced on the operations recorded on accounts type F.

On special bank account type R1 opened *for residents who are either individual entrepreneurs or juridical persons* should be recorded in-and outflows in connection with obtaining a credit or a loan from a non-resident with a maturity of less than three years or the issuing or transfer of foreign securities abroad, while special bank account type R2 likewise opened for *residents who are individual entrepreneurs or juridical persons* should serve to record in-and outflows in connection with extension of credits and loans in foreign currency to non-residents or the purchase or sale of foreign securities. Reserve requirements of 2 per cent of the amount in question are currently imposed on operations resulting in transfers of funds from accounts type R1 with a duration of one year, while for operations resulting in transfers of funds onto accounts type R2 the reserve requirement is 25 per cent of the relevant amount for a period of 15 days.

As with the special account type F, types R1 and R2 also exist as special sections of custodial accounts opened for residents who are individual entrepreneurs or juridical persons for the purpose of keeping a record of foreign securities, either issued by (R1) or held by (R2) them. Thus, foreign securities of the appropriate type shall be entered on or written off residents' special custodial accounts as a result of issuing, acquisition or exchange or transfer of these securities in various ways.

For non-residents:

Special bank accounts type S opened for non-residents by authorised banks shall record rouble-denominated in-and outflows in connection with residents' sale or purchase of government bonds of the Russian Federation. At the present time a reserve requirement of 15 per cent of the amount in question for a period of one year is imposed on transfers of rouble funds to a non-resident's special account type S from the account of a non-resident which is not a special account.

To special non-resident bank account type A are directed in-and outflows in roubles in connection with non-residents' transactions in shares and in participations in investment trusts, while special account type O serves to receive in-and outflows of rouble funds arising from non-residents' transactions in corporate and municipal bonds. There is no reserve requirements currently imposed on type A accounts, while transfers of rouble funds to a non-resident O account from a non-resident account which is not a special account are subject to a 2 per cent reserve requirement for a period of one year.

Special bank accounts type V1 serve for in-and outflows in connection with the receipt by non-residents (who are not banks) of rouble credits and loans granted by residents and from the issuing of domestic rouble securities by a non-resident. In parallel, type V2 serves for the in-and outflows in connection with the granting by a non-resident of a rouble credit or loan to a resident for a term of less than three years or with the acquisition of domestic securities. Operations giving rise to funds transfers from V1 accounts are currently subject to reserve requirements of 25 per cent of the amount of rouble transfers for a period of 15 days, while amounts transferred onto V2 account are subject to a 2 per cent reserve requirement for one year.

The keeping of a record of non-residents' rights to domestic securities for which transactions are executed by means of the above special bank accounts is accomplished by the use of type S, type A and type O special sections of custodial accounts, accordingly. In the case of type A, there is also a special section of a personal account opened by registrars as mentioned above.

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Chapter 7

Recommendations

To sustain recent rise in FDI inflows and further encourage it, Russia needs to enhance its investment policy transparency. Based on the results of the OECD business survey, the Reviews recommends improving information access and simplifying regulations especially in the areas such as land and property registration and work permits, and promoting consultations with the business community on regulatory changes. To ensure that new laws on Special Economic Zones (SEZ) and Concessions have a positive impact on domestic and foreign investment, their implementation should be non discriminatory, transparent and least market distorting. The forthcoming law on "strategic sectors" will be a key test of the government's commitment to transparency. The future law should define the strategic sectors in line with best practice under the OECD instruments, limit the scope of restrictions to foreign investment participation based on essential security interests and clarify the modalities of government review procedures. The Review welcomes the abolition of certain capital controls on 1 July 2006 in advance of the schedule foreseen in the 2004 Foreign Exchange Law and encourages the authorities to adopt supporting measures, including statistical reporting, appropriate tax control, anti-money laundering and non discriminatory safeguards.

Despite recent significant increase of FDI inflows to Russia, FDI stock remains insufficient in view of the country's considerable modernisation needs and FDI sectoral structure is still ill-adapted to overcome Russia's current heavy dependence on the natural resource sector. This situation is also due to the fact that the role of FDI in the overall economic strategy has not yet been clearly defined as reflected in ongoing discussions on the authorised levels of foreign ownership in the so-called "strategic sectors". Russia needs more FDI to boost its financial resources for investment, enhance its technological and managerial know-how and intensify competitive pressures on domestic market to sustain economic growth, upgrade its economic structure and increase efficiency of incumbent firms. To ensure this multifaceted contribution of FDI to economic development, Russia has to develop a comprehensive approach, within which sound macroeconomic fundamentals and an adequate legal framework are the indispensable but not sufficient conditions.

Russia-OECD longstanding co-operation addresses a number of issues which have an important impact on the business environment and are highly relevant in the context of Russia's investment policy, in particular the fight against corruption, transparent and fair taxation, sound competition regime, good corporate governance and regulatory reform. In all these different areas, co-operation aims at supporting the government's efforts to adopt good international practices and instruments, including the OECD Codes of Liberalisation of Capital Movements and Current Invisibles Operations as well as the Declaration on International Investment and Multinational Enterprises. Russia's integration to the world economy will be enhanced by its future accession to the WTO and its participation in OECD investment related initiatives such as the Policy Framework for Investment, which can also contribute to this objective.

The focus of this Review has been on investment policy transparency, one of the key preconditions of a sound investment climate, and its recommendations seek to enhance Russia's policy stance in this essential area.

Russia's international investment statistics provided by the Central Bank of Russia correspond to OECD statistical standards. These data are not, however, consistent with more detailed statistics on geographical and sectoral investment flows published by the Federal State Statistical Service. The Review suggests to compare the methodologies and data coverage used by the

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two institutions and, as much as possible, to seek to consolidate the two data sets with the objective to **disseminate mutually consistent statistics on Russia's FDI flows and positions.**

The recent upsurge in FDI inflows to Russia reflects foreign investors' improved perception of business opportunities in the country, but enhanced policy transparency will remain critical to maintain and boost foreign investors' confidence. The OECD business survey indicates progress in foreign investors' access to business-relevant information, especially at the federal level. Further improvements in information access can be achieved by **selecting right channels for transmitting relevant information to investors, notably through a more extensive use of the internet and in closer co-operation with business and industry associations.**

The OECD survey shows that foreign investors continue to consider very difficult to accede to information on regional legislation and regulations. The proposed **law on information disclosure** submitted by the government in 2005 can be an important step in encouraging the government at all levels to share information with different stakeholders and the public. The Review therefore encourages speeding up the legislative process and ensuring rapid implementation of this law. The Review also welcomes the project of the government to establish the **Register for regional and municipal legislation,** which will supplement the existing Federal Register collecting the texts of federal laws.

Similarly to other recent business surveys, the results of the OECD foreign investor survey indicate that transparency has improved in some areas, such as foreign exchange regulations, but problems have emerged in other areas, in particular land and property registration and work permits, which are usually within the regions' competence. The Review recommends that the authorities **take steps to simplify regulations concerning land and property registration and work permits and ensure their transparent and timely implementation at the regional level.**

Although the legislative and regulatory framework has to evolve, investors need to have timely information on forthcoming regulatory changes and, as much as possible, to be consulted prior to the introduction of new measures so as to avoid that such regulations are unduly complex and represent additional administrative burdens for enterprises. The Review encourages **developing more effective and systematic consultations with interested parties, including with foreign investors,** using more efficiently existing structures such as the FIAC and, when feasible, also associating potential investors and representatives of small and medium-sized enterprises. The existing network of regional Chambers of Commerce and Industry should also be more actively involved in the public-private dialogue, especially with regional authorities.

Costly investment promotion efforts and tax incentives have not been effective in helping regions attract significantly more foreign investment. The Review recommends **assessing the costs and benefits of existing special investment incentives** granted by the regions. The criteria currently used to grant such incentives, in particular on the basis of (high) priority investment projects, should be made more transparent and uniform to avoid excessive discretion by the regional and local authorities.

As much as the **new laws on SEZ and Concessions** do not discriminate against foreign investors**,** they can stimulate foreign investment and allow regions to exploit their potential comparative advantages better. To fulfil these objectives, the laws should minimise risks of market distortions, notably through their non-discriminatory and transparent implementation.

The forthcoming laws on "strategic sectors" and subsoil will be a test of the government's commitment to transparency. It is important that consistent with best practice under the OECD instruments, the law under discussion defines the sectors in question, limits the scope of restrictions to foreign investor participation based on essential security grounds, and clarifies the modalities of government review and permission procedures, in particular by setting clearly the time limits for notifications of government decisions.

Russia has also sought to promote international investment by negotiating **bilateral investmenttreaties** (BIT) and concluded by the end of 2004 52 BITs of which 35 entered into force. These agreements adopt generally a similar approach as most other international investment agreements, though there are some differences regarding for example the scope of exceptions to MFN and national treatment and the inclusion or not of some provisions such as regarding performance requirements and key personnel. **The Review encourages the government to build strong transparency provisions into all Russia's future investment agreements**.

The Review considers that the **2004 Foreign Exchange Law** represents a major improvement for domestic and foreign investors**.** By endorsing progressive liberalisation, non-discrimination and increased transparency, the new Law is consistent with the guiding principles of the OECD Code of Liberalisation of Capital Movements**. The Review welcomes the abolition of capital controls in advance of the schedule initially foreseen in the 2004 Foreign Exchange Law.** Financial market participants have considered the system of controls insufficiently transparent, often ineffective and costly for both foreign and domestic investors. The orderly removal of capital controls needs to be accompanied by supporting measures, including statistical reporting, appropriate tax control, anti-money laundering and non-discriminatory prudential safeguards. The Review also supports efforts to improve information sharing among financial market regulatory bodies in Russia.

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Despite recent growth, the volume of Russia's international investment remains modest compared with major OECD countries. The recent upsurge of inward foreign direct investment (FDI) has not yet translated into a significant share of FDI in GDP and total investment.

The 2006 *Investment Policy Review of the Russian Federation* examines developments in Russia's regulatory investment environment since the publication of the 2004 Review, focusing on investment policy transparency and effective implementation. It includes recommendations to move capital control reform forward, to adopt least-restrictive approaches to legislation on "strategic sectors" and to strengthen Russia's international investment agreements.

This review is part of the long-standing co-operation established between the OECD and the Russian Federation.

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