HERBERT SMITH FREEHILLS

RUSSIA

PRIVATE EQUITY REVIEW

IN THIS REVIEW

August 2016 – ISSUE 4

EXECUTIVE SUMMARY

2015 was another turbulent year for the Russian economy, with low oil prices and currency fluctuations adding pressure to an already difficult climate in which to do business. The headwinds have eased slightly with the modest resurgence in the oil price to almost US$50 a barrel in Q2 2016. However, the economic sanctions, the effect of Brexit and the risk of further currency movements continue to dampen investor interest. Nevertheless, there remain opportunities for those with capital and a clear appreciation of the legal environment within which the target company operates.

"We expect that the remainder of this year will also be characterised by opportunistic acquisitions, often in conjunction with other investors."

In this issue we review deal activity over Q4 2015 and H1 2016 and look ahead to which sectors might be most active in the remainder of 2016. We discuss the significant investments that State-owned Chinese funds have made in Russia in the last 12 months as part of China's "One Belt, One Road" strategy, and the proposed partial privatisation of State assets announced by the Russian government. As highlighted in our previous issue, we consider that the TMT sector will remain one of the most active in the Russian economy in 2016.

We expect that the remainder of this year will also be characterised by opportunistic acquisitions, often in conjunction with other investors. Our second article analyses the potential challenges that private equity investors may face in Russia and how to limit these risks in the context of such joint ventures. For investors unfamiliar with the Russian market, the assistance of a local partner can be indispensable, and as some international private equity investors exit Russia this creates opportunities for others to step into their shoes. We discuss the various contractual protections that investors can negotiate to mitigate structural, management and exit risks, among others.

The final article of this issue considers the current regulatory climate in Russia and highlights some key areas of which investors should be aware. These include recent developments in data protection regulation and laws relating to ownership of interests in mass media, investments into "strategic" Russian companies and the enforceability of non-compete obligations.

HERBERT SMITH FREEHILLS: OUR RANKINGS

Herbert Smith Freehills is the number one legal adviser to Russian M&A in 2015 by deal volume and deal value (according to Mergermarket).

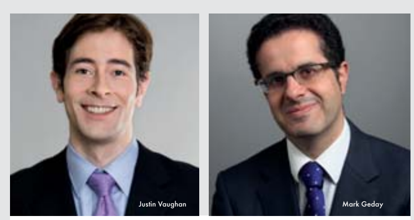
MERGERMARKET BY DEAL VALUE

RANKING	FIRM NAME	VALUE OF DEALS (US$ M)
1	**Herbert Smith Freehills**	**8,498**
2	Norton Rose Fulbright	7,744
3	Dechert LLP	7,005

MERGERMARKET BY DEAL VOLUME

RANKING	FIRM NAME	VOLUME OF DEALS
1	**Herbert Smith Freehills**	**17**
2	White & Case	16
3	Linklaters	8

We were recently interviewed on the Russian PE market for *Getting the Deal Through: Market Intelligence – M&A in Russia*



M&A in RUSSIA

In this interview, we consider the evolving legal and regulatory landscape for M&A transactions in Russia and comment on current trends and possible future developments. The interview is available from the Market Intelligence section of the GTDT Online website. Click here to see the article.

MARKET SURVEY

Market commentators had their pens primed to write eulogies for the Russian economy in 2015; a year characterised by currency fluctuations and plummeting oil prices. Although many forecasts in early 2016 made for more disappointing reading for Russia investors, so far 2016 has shown that there is still life in the old bear and a few upsides to the downturn for those investors with the capital and the capacity to exploit it.

Lauren Long

In particular:

- the low relative value of the Rouble means that production costs in Russia offer significant competitive advantages to investors localising production in the country for export;
- the energy, natural resources and Technology, Media and Telecoms (TMT) sectors, which were among the most active areas of the economy over the last 18 months, look ripe to produce more deals;
- Russian sanctions on food imports have spurred M&A and joint venture opportunities in the food manufacturing and agricultural sectors;
- domestic and Chinese State funds continue to invest in the economy, creating a number of new opportunities; and
- looking ahead, the Kremlin has set the wheels in motion for the privatisation of certain State companies including oil behemoth, Rosneft.

GLOBAL CONTEXT

The Russian economy shrank 3.7% in 2015, in part as a result of the low price of oil (oil revenues count for around 40% of overall federal revenue) which has languished below US$55 per barrel since November 2015 and in the first two months of this year hovered around the US$30 mark. This has put even more pressure on the Russian Rouble which remains depressed at less than half its value to the US Dollar as compared to 2013. The erratic currency fluctuations in 2015 are still perceived as a risk for investors, making it difficult to plan for, and value, investments.

The weak currency has in turn suppressed domestic consumer spending in Russia, and combined with the continued impact of EU and US sanctions relating to events in Ukraine, has curbed the desire for, and practicality of, inward foreign investment. In particular, it has limited the ability of banks such as VTB, VEB, Gazprombank and Sberbank (all subject to sectoral sanctions restricting access to new capital) to provide finance to investors or for on-going operations.

OUTBOUND INVESTMENTS AND EXITS

There were some large deals in 2015 (predominantly in the energy sector) including private equity fund Gaetano Holdings' acquisition of Komi Oil refinery company for €4.7 billion in Q4 2015. However, overall, deal sizes have generally become smaller and deal volumes have decreased, with the flow of new foreign direct investment slowing to a trickle. A number of foreign companies decided to withdraw completely from the Russian market in the last 12 months (including ConocoPhillips which exited in December 2015 after 25 years in Russia and Vitol, in turn, earlier this year). Further the Blackstone Group, a potential new entrant, has reportedly ended its hunt for Russian investment opportunities. But not all foreign players in the market are giving up. That said, a number of domestic private equity firms have instead turned their attention abroad to invest their capital. In October 2015, Mikhail Fridman's LetterOne Group invested US$ 1.6 billion in E.On's offshore Norwegian oil & gas fields and it continues to look outside of Russia for opportunities.

PIVOT EAST

A drying up of Western private equity investment through 2015 has been counterbalanced to an extent, by some movement in the long-awaited "pivot East".

In December 2015, China's Silk Road Fund (a State-owned investment fund) acquired a 9.9% equity stake in the Yamal LNG project from Novatek and agreed to loan Novatek €730 million to finance the project. A further US$ 12 billion worth of loans for the Yamal project were agreed in May 2016 with Export-Import Bank of China and the China Development Bank. Also in the natural resources sector, Highland Fund (a consortium of Chinese investment funds and corporations) made a US$ 100 million investment in 13.33% of Norilsk Nickel's Bystrinsky copper project. China's "One Belt, One Road" strategy (aimed at increasing trade and investment through infrastructure development and reducing trade barriers along the ancient silk road) means that we expect this will continue to be a theme of private equity M&A in H2 2016.

The Russia-China Investment Fund (RCIF), a private equity fund formed in 2012 by the Russian Direct Investment Fund (RDIF) and the China Investment Corporation, renewed its commitment to focus up to 70% of its capital investments into Russia (with the balance to be invested in China). In January, in the first major private equity deal of 2016, RCIF acquired 23.1% of JSC Detsky Mir from a subsidiary of Sistema for RUB 9.75 billion. Additionally, it was reported in December 2015 that RDIF, Renaissance Capital, Onexim Group and CITIC Merchant had agreed to set up a strategic partnership in relation to investments in projects by Russian and Chinese players in Russia, the CIS, and elsewhere.

> *"A drying up of Western private equity investment ...has been counterbalanced... by some movement in the long-awaited 'pivot East.'"*

Additionally, we are increasingly seeing investors from the Middle East taking minority interests in Russian investments.

SECTOR ACTIVITY: TMT

In our previous issue we noted that Russian TMT companies are some of the few targets for private equity investors that are forecast to deliver growth despite the current economic and geo-political situation in Russia. A certain amount of activity in the TMT sector in the last 12 months was prompted by legislative changes such as the new limits on foreign ownership of media interests. In February 2016, Sony Pictures Television reduced its stake in the Russian arm of its business to 20%. Vladimir Khanumyan, a former senior manager of Gazprom Media now owns the remaining 80% interest. The change in law was likely also a consideration in Finnish-listed Sanoma Corporation's divestment of its 50% stakes in magazine groups Fashion Press and Mondadori Independent Media and its remaining participation in United Press to Russian InVenture Partners in December 2015. Although many foreign investors are leaving this sector, foreign players are also making their presence felt: in one of 2015's most notable deals, African internet major Naspers acquired a majority stake in Avito, Russia's largest classifieds site, for US$ 1.2 billion. We anticipate that this sector will remain an area of interest for private equity investors in the remainder of 2016 particularly in the mobile and internet-related sub sectors, given the very strong penetration of smartphones and high levels of internet use in the domestic market. As an indication of this continuing trend, conglomerate Otkritie recently (April 2016) saw off rival bidders to acquire mobile banking start up RocketBank and, at the other end of the spectrum, in late 2015 VimpelCom commenced a tender process for the sale of its Russian wireless tower infrastructure assets. Many foreign and domestic private equity funds were rumoured to be interested in this tender (estimated value around US$ 500 million), although market sources suggest that the process is currently on hold.

OTHER M&A OPPORTUNITIES

We expect that M&A activity in other sectors in 2016 will be driven by opportunistic acquisitions as cash-strapped businesses look to divest non-core assets, such as Sistema's acquisition of Russia's largest greenhouse farm, Yuzhny agricultural complex, from VTB banking group in late 2015. Market sources also suggest that a number of foreign companies are looking at expansion opportunities into the Russian food and agricultural industries. An example of this is the memorandum of understanding signed in May of this year by a consortium of Russian, Chinese, Thai and Middle Eastern investors to invest approximately US$ 1 billion into developing a large dairy plant in Ryazan. As highlighted in our previous edition the economic crisis prompted a dramatic increase in distressed M&A in 2014/15; as a large number of Russian companies are still falling into administration, we expect this will continue where there is value to be salvaged. It has been reported that Razgulay Group is selling certain of its sugar plants, grain, flour and bread interests after a bankruptcy claim was filed against it. Also in the rumour mill: joint venture partners have been sought for several Russian mining projects including Northern Territories and Kopylovskoye projects currently owned by Stockholm company Kopy Goldfields, the Udokan copper deposit owned by Alisher Usmanov through Metalloinvest, and debt and equity investments sought for Australia's Tigers Realm Coal's (which counts RDIF and Baring Vostok as shareholders) Chukotka interests. Meanwhile, LSE-listed mining company Petropavlovsk is to form a joint venture with GMD Gold to complete a processing facility at its Pokrovskiy mine that turns refractory ore into gold. In April this year, Petropavlovsk also inked a deal to acquire Amur Zoloto, another Russia-focussed gold miner.

POSSIBLE PRIVATISATION OF STATE COMPANIES

The Russian government announced in January 2016 that it will sell minority stakes in certain State enterprises to deal with the national budget deficit. Presidential approval for the sale of Bashneft was given in May of this year and companies including Rosneft have reportedly filed applications to acquire a stake in the oil firm. Other possible targets for State divestment include lender VTB, shipping company Sovcomflot and petroleum giant Rosneft, itself. Initial indications that Sberbank could be on the list have been rejected by government ministers. Media reports suggest that the Kremlin intends to limit the involvement of State banks in any sale. This might create opportunities for private equity to step in although market reports suggest that interest in Bashneft is lukewarm among the major Russian investors. Following suit, the Republic of Tartarstan is reportedly planning to sell stakes in oil and petrochemical interests, including stakes in Tatneft (listed in London and Moscow), Nizhnekamskneftekhim (listed in Moscow) and TANECO. In the first of such privatisations, 10.9% of miner, Alrosa was sold for US$ 813 million to various Russian and international investors in July. However, the timing may not be ideal for the sale of other major State enterprises. Rosneft and VTB's inclusion on Western sanctions lists may lower the price of any valuation for potential investors and consequently cool the feet of government ministers to push a sale. As with the other aspects of the Russian private equity market in 2016, the potential is certainly there, but only time will tell.

INVESTMENT IN RUSSIA: OPPORTUNITIES AND RISKS

Against a backdrop of low prices and geopolitical uncertainty, the opportunities and potential rewards for foreign investors are growing and changing, and so are some of the risks. This article looks at the main challenges presently facing foreign and domestic private equity ("PE") investors and assesses how they can be mitigated, particularly in the context of joint ventures with local partners.

Martyn Jones

OPPORTUNITIES AND RISKS

Earlier this year, major news agencies began reporting a potential privatisation of Russia's State-owned assets. We have heard this before, of course, but it can be given greater credence now as a confluence of domestic and international factors contributes to Russia's widening budget deficit. One way to plug the gap is the sale of interests in State-owned companies, with the aviation, transport, oil, banking and mineral sectors all offering potential opportunities for PE investors. While these opportunities are open to both domestic and foreign players, foreign investors have been courted actively. While many PE Investors will be wary of investing in politically exposed industries, speaking in February 2016, Dmitry Peskov (spokesman for Russian President Vladimir Putin) stated that "Russia was and remains open for foreign investment and Russia is interested in attracting new foreign partners". The same macro factors also result in private Russian companies seeking investment and a lack of local capital means that foreign investors are highly sought after. With the Rouble having lost around half of its value against the US Dollar since early 2014, both State and non-State-owned Russian assets represent potential value for PE investors.

LOCAL PARTNERS

Regulatory risk is a key concern for PE investors, both for those considering entering the Russian market, and many local as well as experienced foreign PE investors (as noted in our article on Russian regulatory issues starting at page 8).

As we highlighted in our article on consortium deals in Russia in the *June 2014* issue, there are a number of advantages for a foreign PE investor in teaming up with a local partner, either as a minority investor where the Russian incumbent retains control or as part of a consortium with a Russian co-investor.

There remains a premium on local knowledge and connections, which can be indispensable for all investors, particularly foreign investors who are unfamiliar with the Russian regulatory system and lack relations with the Russian authorities. A local partner also allows the foreign investor to benefit from the experience, expertise and influence of its partner, which is likely to already be active in the relevant sector.

For local players, as well as the obvious benefit of accessing capital, attracting international investors may bring the benefit of a greater depth of deal experience and sector knowledge.

FINANCE CONNECTIONS

PE investment in Russia has not traditionally depended heavily on acquisition finance to leverage PE acquisitions. However, as Russian corporates are increasingly facing funding difficulties, the provision or sourcing of financing by an incoming shareholder is often included as a condition precedent to deal completion.

While a foreign investor will of course bring its own capital to the table to fund the acquisition, of equal or greater importance may be its ability to source funding from banks based in the same overseas jurisdiction.

This is something of a double-edged sword; foreign investors may be able to leverage their position to secure a better deal (whether on price or gold-plated minority protections), but could also find there is no deal at all if third party funding from their home jurisdiction is not secured.

FOLLOWING IN ANOTHER'S FOOTSTEPS

We generally see fewer greenfield investments in Russia, with a greater proportion of PE investors investing in mature joint ventures, either because further capital is required or as a pre-exit cornerstone investor. Investing in a Russian JV structure as the second (or even third or fourth) foreign investor creates its own challenges and risks.

On the positive side, the earlier investors will likely have done much of the work required to create a viable structure with meaningful contractual protections for the incoming PE investor. On the other hand, there may be more limited scope to negotiate a bespoke deal: while the practice has never been for the incoming partner simply to execute a 'Deed of Adherence' and so adhere to numerous terms and conditions negotiated by other parties with different prerogatives, it can be more difficult than in previous years to agree significant concessions that were not given to previous investors – local partners are usually more sophisticated than in the past, current investors are often unwilling to see newcomers gain advantages that were not available to them, and overall the complexity of negotiations increases with the number of partners. Therefore an incoming PE investor is likely to find it difficult to impose its own institutional terms on the deal and may have to accept more compromises than would otherwise be the case; perhaps drawing comfort from the presence of other international investors in the joint venture.

SANCTIONS AND REPUTATIONAL RISKS

Sanctions remain a key concern for European and US investors, likewise for local funds that have US or European limited partners or otherwise seek to access US or European financing, and the approach taken by PE investors will vary on a case-by-case basis. We are seeing both foreign and local PE investors demand broad bespoke undertakings to comply with applicable sanctions and anti-bribery and corruption legislation, together with ongoing diligence and reporting obligations. Mitigating the real or perceived risk of reputational damage is one of the remaining areas where these investors are able to leverage their strong negotiating position.

There is a growing trend also for PE investors to go further, in some cases requiring significant changes to the target to be made prior to completion (including the divestment of non-core assets), or insisting upon a 'Put Option' (at market or other pre-agreed price) in the event that sanctions or other regulatory risks make its position as a shareholder untenable. Increasingly, these conditions are accepted by domestic players keen to attract investment, who can be less willing to give ground in other areas but remain mindful of the reputational sensitivity of international investors.

JOINT VENTURE STRUCTURES

The basics of joint venture structuring in Russia have become more open for debate. Previously, it was an article of faith that a "classic" off-shore JV structure (most often with the JV company domiciled in Cyprus, the Netherlands or Luxembourg) with a shareholders' agreement ("SHA") governed by English law was the only way to structure a joint venture in Russia.

Even then, it was our view that the risk was overstated, and that an onshore JV could, through careful structuring, adequately protect a minority investor in a Russia context with many of the refinements commonly seen in an offshore structure. Now, Russian policymakers' clear preference for onshore structures has translated into changes to the Russian legal framework, which now expressly recognises key terms of shareholder agreements, such as options, drag along and tag along rights. Despite the complexity of the documentation required and the small number of firms with real expertise in this area, an onshore JV regulated by Russian law is now a viable, if infrequently chosen, alternative for PE investors.

INVESTMENT IN RUSSIA: OPPORTUNITIES AND RISKS

MANAGEMENT AND CONTROL

A key potential risk is the lack of control and visibility a PE investor may have over the underlying Russian business.

One of the most important questions for a foreign investor therefore is the management rights that will be afforded to it – will the foreign investor take an active role in the day-to-day operations of the target group, or will it be content to allow its local partner to maintain operational control subject to more or less limited oversight rights?

A foreign investor will usually want to appoint at least one director (or an observer having the right to attend board meetings and receive the same information and materials as directors) as well as to have control over the appointment and removal of the general director(s) in Russia. Most investors will also require the right to appoint at least one member of the various committees (such as the steering committee) that constitute the governing bodies of the group.

DISPUTE RESOLUTION MECHANISMS

As investors are becoming both more sought after and more experienced, we are seeing their list of demands increase as PE investors seek more than basic minority protections (such as anti-dilution, amendments to constitutional documents, dividends), and increasingly look for a greater level of control over commercial matters (such as key contracts, material acquisitions, recruitment of senior management).

A longer list of reserved matters creates inevitably greater potential for disputes. There are a number of mechanisms that may be used to resolve a deadlock scenario, although many of these will usually be unattractive to PE investors. For example, PE investors are unlikely to favour 'Russian roulette' or 'Texas Shoot-out' dispute resolution mechanisms that result in the PE investor either exiting the project before it would otherwise wish to do so or being forced to buy out its local partner. Any type of 'casting vote' mechanism that allows the local majority partner to take key decisions without the consent of the PE investor will be similarly unacceptable.

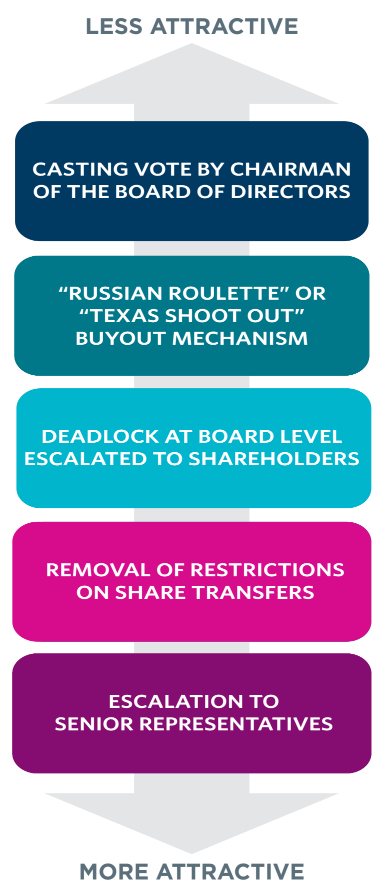
The most favoured approach is for disputes to be escalated to senior representatives, with PE investors preferring to give themselves flexibility to cut a deal at the time rather than agreeing a complex mechanism upfront.

An interesting alternative for sophisticated PE investors would be for the share transfer restrictions (see later section) applicable to the investor to 'turn-off' where there is a prolonged deadlock. This may allow for an alternative exit when a partnership has gone sour, but does need to be carefully managed; an exit on acceptable terms during a dispute scenario may be difficult to achieve in practice.

EXIT

A clear path to exit is critical for a foreign PE investor, much more so than for a strategic buyer. On the flip-side, local partners will want their foreign partner to be committed and invested in the business for at least a minimum period. This tension gives rise to a number of potential SHA provisions, each of which may be heavily negotiated.

Given PE investors' strong negotiating position in the current climate, we are increasingly seeing investors accepting less risk and pushing for greater economic protections as well as ongoing control rights.



"A key potential risk is the lack of control and visibility a PE investor may have over the underlying Russian business."

"... PE investors are unlikely to favour 'Russian roulette' or 'Texas Shoot-out' dispute resolution mechanisms ..."

"A clear path to exit is critical for a foreign PE investor, much more so than for a strategic buyer."

The table below highlights some common provisions and the issues that may arise.

MECHANISM	POINTS TO CONSIDER	PE ANGLE
Lock-up: total prohibition on transfer of shares to third parties Ensures commitment of parties during initial establishment phase	Affiliate transfers usually permitted subject to credit-worthiness and transfer back provisions Upstream lock-up – how to define 'Change of Control' and potential remedies for breach	Robust lock-up and change of control provisions are usually in both parties' interests Multiple PE investors may ask for freedom to transfer interests between each other; but important to consider how this affects the balance between the shareholders
Pre-emptive rights: allow a party to sell its shares to a third party, provided the shares are first offered to the other party	Avoids being forced into joint venture with undesirable third party ROFO vs ROFR (see graphic below)	PE investors are seeking longer periods in which to decide whether to exercise pre-emption rights; increasingly demanding time to conduct a full due diligence exercise
Tag-along: allows a shareholder to require a seller to procure that its third party buyer also buys the shareholder's shares on the same terms	Sought by minority shareholders who would not want to remain in the JV with another majority shareholder, or as a means of maximising exit price	PE investors are increasingly insisting on a tag in situations where the value of the investment is heavily dependent on the relationship with a local partner Investors may also seek to agree upfront that no business warranties will be given in the event of a tag-along
Drag-along: allows a seller to force the other shareholder to sell its shares to the third party buyer on the same terms	Sought by majority shareholders as a means of enhancing their prospects of sale and an attractive sale price by allowing them to offer 100% of the JV to the third party buyer	PE investors are increasingly seeking higher hurdles for the majority shareholder to enforce the drag; a forced exit is acceptable only on preferential terms

ROFO VS ROFR

A common negotiation point is whether pre-emption rights should be structured as a right of first *offer* ("ROFO") or as a right of first *refusal* ("ROFR"). Although the exact mechanisms may differ, the general timeline is set out below:

ROFO –

- A decides to sell its shares
- A is required to first offer B* the option to acquire A's shares on terms determined by A
- B accepts or rejects the offer
- If B accepts the offer, B buys the shares from A
- If B rejects the offer, A may sell its shares to third parties provided that the terms are no worse for A

ROFR –

- A decides to sell its shares
- A markets shares and receives binding offer from third party to buy A's shares
- A is required to deliver notice to B, offering B the option to buy A's shares on the same terms offered by the third party
- If B rejects offer, A is free to complete the sale to the third party within a prescribed time period

* an alternative version of the ROFO exists where B offers a price for A's shares which A may accept or reject, but if A rejects, it cannot sell its shares to a third party for a lower price.

Given that these provisions are likely to be mutual and a ROFO generally results in greater liquidity, a PE investor will need to carefully consider whether stability or flexibility is the higher priority.

A RISK WORTH TAKING?

Over the past few years, it is true that political, economic and regulatory uncertainty has dampened the enthusiasm of many international PE investors when it comes to deploying capital in Russia.

However, a relatively investor-friendly regulatory framework, a weak Rouble and low prices create opportunities for investors with the right experience, knowledge and connections.

REGULATORY ISSUES IN RUSSIA

Evgeny Yuriev

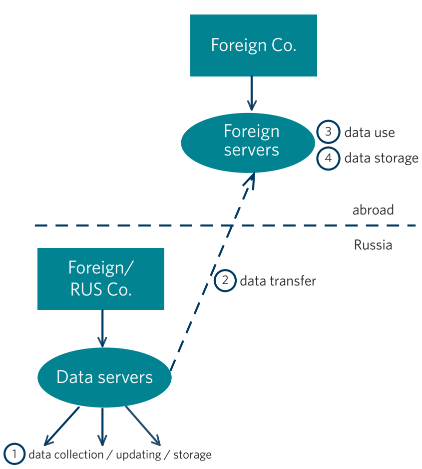
In recent years the regulatory piece has commanded increasing attention in deals involving private equity ("PE") sponsors in Russia. This stems from both unexpected developments in the Russian regulatory framework, and the sensitive sectors and themes on which recent PE activity has centred. This article highlights four of the most pressing current areas for regulatory analysis in PE deals.

1. DATA PROTECTION

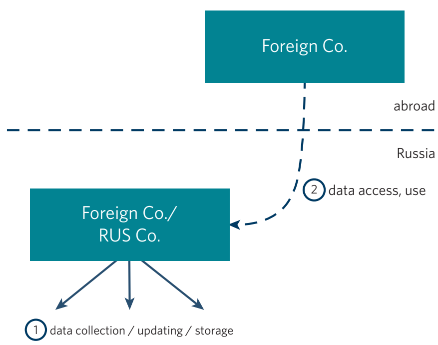
As highlighted in our September 2015 issue, TMT remains a relatively lively sector in the Russian market, especially internet-heavy and cloud-based businesses. Recent developments in data protection are therefore of particular relevance for PE sponsors.

The developments in question flow from the so called "Data Localization Law" (otherwise referred to as Law No. 242-FZ) which has been in effect since 1 September 2015. Amongst other things, the Data Localization Law provides that, when collecting personal data of Russian nationals, the data operators must ensure that the storage and updating of such data is carried out through Russian servers – that is, servers located within the territory of the Russian Federation.

Examples – allowed



Examples – allowed

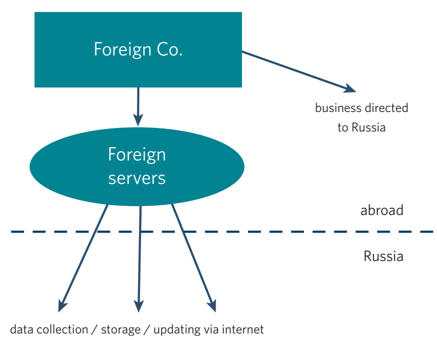


The Data Localization Law applies to various activities, including internet services such as online booking, social networking, data storage and payment systems. The Ministry of Communications (the State authority to which the data protection regulator reports) recently announced its view that the Data Localization Law will also apply extraterritorially to companies having no presence in Russia but operating internet services which target a Russian audience. Unlike some other jurisdictions, Russian law has had limited extraterritorial application. This new regulatory approach to data protection law departs from the formerly known regulator's approach according to which operators would need to be present in Russia (including through branches or subsidiaries) to be caught by Russian data protection laws.

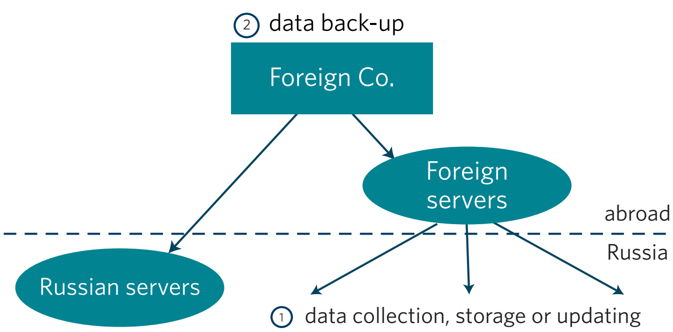
This interpretation of the new law may significantly affect the IT infrastructure operated by target companies, especially where this is an inseparable part of their global infrastructure. Compliance with the Data Localization Law may also require significant additional capex relating to the acquisition or leasing of Russian data servers because many target companies may operate centralised data storage abroad.

Recently, the Ministry of Communications has sought to reassure the industry, by announcing that the new Data Localization Law should not create any impediment for legitimate cross-border data transfer and should essentially require primary storage and updating in Russia with the possibility of data being backed-up overseas. At the same time, in the absence of an established court or regulator's practice to date, the exact implications of the new law remain to be seen. With the rise of data residency laws globally and Russia's trend of increasing control over the internet and personal data, there is currently no major relaxation of the data protection regime on the horizon.

Examples – not allowed



Examples – not allowed



As a negotiation point – given the above-mentioned uncertainty around the new Data Localization Law, PE sponsors acting as buyers should request a specific warranty to the effect that all data is exclusively stored and updated in Russia. At the same time, we have seen that sellers are reluctant to provide such a specific warranty, and typically appeal to their general compliance with law warranty so that they can entertain their own interpretation of compliance in this area: in the absence of uniform practice and clear regulator's guidelines (or a specific claim by the regulator) it could be difficult in practice for buyers to make a claim for breach of the Data Localization Law based on the general compliance warranty.

2. STRATEGIC INVESTMENTS

Another important regulatory issue for PE investment into Russian TMT businesses is the consent requirement under the Strategic Investments Law 57-FZ ("SIL"). The SIL applies to investments into strategic Russian companies and requires that prior consent be obtained from the Governmental Commission (chaired by the Prime-Minister) for an acquisition of control (including negative control) over a strategic target.

"Strategic" Russian companies include, amongst many others, dominant telecoms, tele- and radio-broadcasting companies covering more than half of any constituent territory's population, and major printed media ("Territory" is not defined in the SIL; typically a broadcasting licence would state the territory by reference to particular city(-ies)/town(s)). There have been several high-profile cases where consent under the SIL was required and usually it is a foreseeable regulatory condition.

At the same time, while these may seem like clearly identifiable and rarely triggered criteria, an unintended consequence of the criteria for strategic targets is that any IT company holding a licence for encryption (which is a common occurrence, particularly for cloud-based companies and those with proprietary messaging systems) may also be caught within the definition. Therefore, the SIL may come into play counter-intuitively and apply to targets and sectors which, on the face of it, do not have strategic underpinning. While the regulator has relaxed the consent requirement in some areas (eg for the acquisition of private banks holding encryption licences), PE sponsors need to be alert at all times to the potential impact of the SIL in the TMT sector. The Governmental Commission has considered around 400 filings since the enactment of the SIL, and as of 2011 (the last year for which a breakdown by business sectors is available), TMT filings accounted for approximately 8% of all applications.

The main issue with seeking such consent is timing: it may take six months or more to obtain clearance. Furthermore, the regulator may impose certain conditions alongside the consent, including reporting and local content requirements.

However, an exemption applies to investments where the acquirer is controlled by a Russian national (being a Russian tax resident and having no foreign citizenship).

We recommend that the legal due diligence should include the review of licences for licensable activities in Russia and that PE sponsors seek a warranty from the seller(s) to the effect that neither the target nor any of its subsidiaries is a strategic company for the purpose of the SIL.

The likelihood of regulatory conditions being imposed means that the investment agreement should state explicitly that the terms of consent must be satisfactory to the PE investor, and that such consent shall not be withdrawn or amended.

3. MASS MEDIA

As from 1 January 2016, foreigners are prohibited from controlling, directly or indirectly, more than 20% of any Russian mass media organisation. At the same time, intermediary foreign ownership is exempted from the law to the extent that one or more Russian beneficial owners ultimately control at least 80% of the foreign intermediary. This exemption will be available until 1 January 2017.

Whilst this development has attracted significant market attention and led to a number of exit transactions, other, similarly significant amendments to Russian mass media legislation came into force on 10 January 2016. These amendments require Russian mass media organisations to declare any foreign financing to Roskomnadzor (the Russian mass media regulator) including the following: details of the funding party, legal grounds for the funding (eg equity, debt, donation, etc.) and a copy of the underlying financing arrangement. A general de minimis threshold of RUB 15,000 applies and a specific exception from the reporting requirement is made for funds received from foreign organisations for paid advertisements. The disclosure is required to be made in every quarter in which foreign funding is provided. The rules do not require disclosure for any repayment of funding. A failure to comply may result in a fine being imposed in the amount of up to two times the amount of the foreign financing received.

The reporting requirement echoes a relatively recent law requiring that non-commercial organisations in Russia, which engage in a widely understood political activity and which receive foreign funding, be registered as

REGULATORY ISSUES IN RUSSIA

"foreign agents" in Russia and indicate this status in all their communications. As one would expect, the new reporting rules have been poorly received by the industry, in particular due to the very wide scope of their application and extensive disclosure requirements. No further legislative developments have been reported, but we expect that there may be further lobbying in the future with the aim of obtaining further exemptions.

PE sponsors should be mindful of this requirement when having to deal with the portfolio company's reporting to State authorities.

4. NON-COMPETES

Challenging market conditions have heightened interest in investment protections and there has been a corresponding increase in key sponsors' legitimate interest in protecting their investment against any harmful competition from the seller side. As many market participants are aware, arrangements that breach antimonopoly laws are potentially unenforceable and can result in turnover-based fines being imposed on its parties. A nuanced approach to each protective measure, together with careful analysis and drafting, is therefore required.

Although court practice has not been uniform and very few approaches have been made by the Federal Anti-Monopoly Service ("FAS") to determine the issue, a number of trends have emerged which can help investors to understand which non-compete arrangements may be permitted and which may not.

As is consistent with the only available FAS guidelines to date on this issue – the FAS has recently taken a more permissive approach towards non-compete undertakings contained in "true" joint venture arrangements, recognising that competition against the target business by a shareholder or exiting seller may have a material adverse effect on the target's business, or otherwise materially and adversely affect the ability of the investor to recover its historic and ongoing investments. At the same time, the FAS has taken a strict approach regarding the timing of the relevant arrangement, and has been sceptical about any extension beyond the life cycle of the joint venture.

Despite these trends, the stakes involved and absence of uniform approach means that each arrangement continues to require careful thought and, as appropriate and if timing allows, clearance with the FAS in advance of being implemented.

Enforceability of non-competes in Russia depending on their term – current trends

For the JV life	Post JV life cycle	Outside the JV scenario (eg sale of 100%)
Potentially enforceable subject to the regulatory test	Potentially unenforceable and risky	Potentially high risk but practice is yet to be developed (often enforceable in other jurisdictions subject to certain conditions)

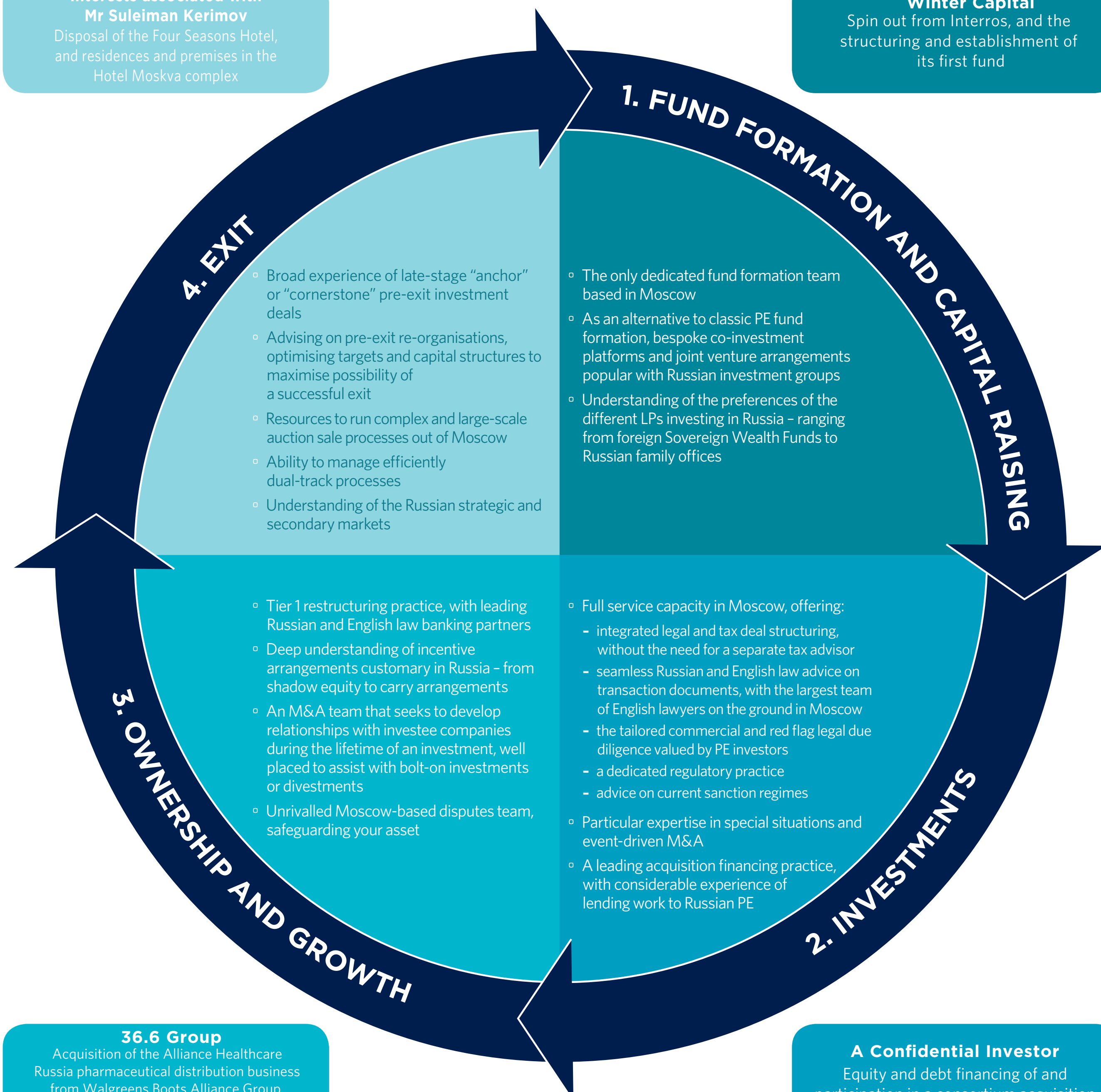
For more information about any of the above topics or any other regulatory developments in the Russian market, please contact **Oleg Konnov, Alexei Roudiak** or **Evgeny Yuriev.**

ABOUT HERBERT SMITH FREEHILLS

Herbert Smith Freehills advises on all aspects of private equity transactions in Russia and is the only law firm which has a dedicated PE team on the ground in Moscow, including funds lawyers.

Interests associated with Mr Suleiman Kerimov
Disposal of the Four Seasons Hotel, and residences and premises in the Hotel Moskva complex

Winter Capital
Spin out from Interros, and the structuring and establishment of its first fund



36.6 Group
Acquisition of the Alliance Healthcare Russia pharmaceutical distribution business from Walgreens Boots Alliance Group, and sale of 15% of PJSC "Pharmacy Chain 36.6" to Walgreens Boots Alliance Group

A Confidential Investor
Equity and debt financing of and participation in a consortium acquisition of HeadHunter.ru

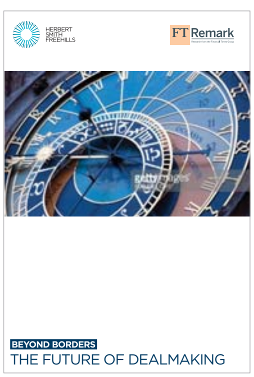
A SELECTION OF OUR RECENT RANKINGS

IFLR 1000 2016	
1ST TIER	BANKING
1ST TIER	RESTRUCTURING AND INSOLVENCY
1ST TIER	ENERGY
2ND TIER	M&A

CHAMBERS GLOBAL 2016	
1ST TIER	CORPORATE/M&A
1ST TIER	BANKING AND FINANCE
1ST TIER	ENERGY AND NATURAL RESOURCES
1ST TIER	RESTRUCTURING AND INSOLVENCY
2ND TIER	TAX

CHAMBERS EUROPE 2016	
1ST TIER	PRIVATE EQUITY
1ST TIER	BANKING AND FINANCE
1ST TIER	CORPORATE/M&A
1ST TIER	ENERGY AND NATURAL RESOURCES
1ST TIER	PPP
1ST TIER	RESTRUCTURING AND INSOLVENCY
2ND TIER	TAX

LEGAL 500 2016	
1ST TIER	BANKING AND FINANCE
1ST TIER	CORPORATE/M&A - MOSCOW
1ST TIER	PPP
1ST TIER	DISPUTE RESOLUTION - ARBITRATION AND MEDIATION
2ND TIER	TAX
2ND TIER	TMT



BEYOND BORDERS: THE FUTURE OF DEAL MAKING

This is the first edition of the global cross-border M&A report, carried out in association with FT Remark, the research division of the FT.

The report canvasses the opinions of 700 senior executives at major businesses around the globe on their experiences of cross-border M&A and their views on the outlook for M&A activity over the next three years. The original survey was conducted at the end of 2015 but, in order to capture any change in sentiment due to the market downturn in early 2016, the report also includes a second study of a significant cross section of the same respondents, providing a comprehensive review of the current M&A landscape. To download the full report please visit www.herbertsmithfreehillsbeyondborders.com.

CLIENT SERVICE AWARD
CHAMBERS EUROPE AWARDS 2015

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MERGERMARKET FULL YEAR 2015

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