

Venture capital investment in Russian Federation: market and regulatory overview

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MARKET OVERVIEW

1. What are the main characteristics of the venture capital market in your jurisdiction?

Venture capital and private equity

Unlike the Russian private equity market, the Russian venture capital (VC) market is a relatively recent development, coming of age less than ten years ago, and still not having fully matured. VC investments are typically riskier than private equity investments and are generally made in earlier-stage companies with a high growth potential.

Sources of funding

Sources of VC funding are both public and private.

Private VC investors consist of:

- Venture capital funds.
- Private equity funds active in the technology sector.
- Incubators and accelerators.
- High net-worth individuals.
- Angel investors.

Public funding accounts for a significant portion of VC investments. There are a several VC funds, such as:

- Rusnano.
- Russian Venture Company (a fund of funds).
- Internet Initiatives Development Fund.
- Venture Fund of Republic of Tatarstan.

Two state institutions provide the majority of grants to Russian emerging companies:

- The Skolkovo Foundation.
- The Fund for Assistance to Small Innovative Entrepreneurs in Science and Technology (Bortnik Fund).

Types of company

Generally, high technology companies with a potential for high growth attract VC investments. The Russian IT sector is the most active sector, constituting about 90% of the total market, both by the amounts invested and by the number of transactions. The most active sub-sectors of the IT sector are:

- E-commerce.

- Advertisement.
- Cloud and software.
- Social networking.
- Referrals services.

Online travel services and fintech are also active.

Market trends

Having peaked in 2012, Russian VC market activity has since declined (both by the volume and by the number of transactions) but it still remains robust, especially relative to the general economic slowdown in Russia.

The number of grants to technology companies have been steadily growing:

- A 35% increase in 2015 compared to 2014.
- A 55% increase in 2015 compared to 2013.

In 2015, the Russian VC market has shown some resilience. In 2015, while the volume of US dollar transactions declined more than 50%, the overall number of transactions grew 20% more than in 2014. The Russian rouble's depreciation against the US dollar by about 40% explains most of the decline in volume.

The average transaction size has also declined (US\$1.5 million in 2015 compared to US\$3.3 million in 2014 and US\$3.1 million in 2013). Exits on the other hand have been growing (both by volume and by transactions size), which indicates that the market is maturing.

2014 saw a 55% increase in the number of grants to technology companies compared to 2013.

In addition, a number of new foreign VC players entered the Russian market in 2014 and 2015.

2. Are there any recent or proposed regulatory changes affecting the venture capital industry?

In 2014 and 2015, amendments to the Russian Civil Code and the Russian Joint Stock Company Law became effective, clarifying several existing Russian law concepts and introducing into Russian law several new concepts typical in common law-governed transactions, such as:

- Warranties and indemnities.
- Put and call options.



- Rights of parties to shareholders agreements, including voting rights.
- Potestative conditions precedent.

Although usual in common law-governed transactions, these concepts under Russian law are still subject to significant uncertainties and remain largely untested in the courts. While these changes constitute a step forward, bringing into Russian corporate law concepts commonly used in other jurisdictions, many tools are still lacking. In order to use the standard VC toolkit, parties generally incorporate the investee company in a non-Russian jurisdiction (*see Question 12*), a practice that is expected to continue in the near future.

TAX INCENTIVE SCHEMES

3. What tax incentive or other schemes exist to encourage investment in venture capital companies? At whom are the schemes directed? What conditions must be met?

IT companies

Russia-based IT companies engaged in software development and sales activities, and/or provision of technical services for developed software, are eligible for reduced rates of insurance contributions until 2019 (14% to 28% compared to the standard 30%).

Expenses for certain types of research and development activities can be deducted at 150% in the period incurred, regardless of the result of the research and development activities.

Skolkovo tax incentives

Certain tax benefits are available to Russian companies that are residents of the Skolkovo Innovation Centre. Generally, Russian companies can become a Skolkovo resident if they conduct qualifying research and development and innovation activities, and comply with certain other requirements.

The main tax benefits are:

- Profits tax exemption for ten years.
- Social insurance contributions at a reduced rate of 14%.
- A VAT exemption.

Sale of shares in Russian companies

Income is taxed at a 0% profits tax rate from the sale of:

- Unlisted shares.
- Listed shares in high-technology Russian companies.
- Shares in "non-property-rich" Russian companies.
- Participation interests in Russian companies acquired after 1 January 2011 and held for at least five years.

Income from sale of equity interest in Russian companies acquired after 1 January 2011 and held for at least five years is exempt from Russian individual personal income tax.

Russian participation exemption

Dividends received by a Russian company from an over 50% held subsidiary held for a period of 365 consecutive days are taxed at a 0% profits tax rate. The 0% tax rate is also applicable to dividends received from non-Russian companies if the country of residence of the foreign company is not included on a so-called "blacklist" of offshore countries (*Order*

of the Russian Ministry of Finance No. 108n, dated 13 November 2007).

Special economic zones, territories of advance social and economic development and regional tax concessions

Companies that are resident in the special economic zones, participate in regional investment projects, or are registered in territories of advance social and economic development or certain regions of Russia are, depending on their activities, entitled to several tax benefits, including an:

- Exemption from property tax and land tax.
- Reduced profits tax rate.
- Reduced insurance contributions rate.

4. From what sources do venture capital funds typically receive funding?

Russian sources of funding for venture capital (VC) funds are mainly:

- High net-worth individuals.
- Corporations
- The state.

The Russian Venture Company, a Russian sovereign fund of funds, invests in VC funds focused on Russia.

Foreign funds active in Russia generally raise their funding from:

- Corporations.
- Sovereign wealth funds (often Middle-Eastern and Asian).
- University endowments.
- Insurance companies.
- Pension plans.
- High net-worth individuals.

FUND STRUCTURING

5. Can the structure of the venture capital fund affect how investments are made?

The investment policy of a venture capital fund typically specifies restrictions on the investment the fund is permitted to make concerning industry sector, investment size and geography. The fund's investment committee, consisting of the general and major limited partners' representatives, as well as independent members, make investment decisions within the confines of the investment policy.

6. Do venture capital funds typically invest with other funds?

Venture capital funds routinely co-invest with other funds. One fund typically leads a round and can "syndicate" it. The syndication decision is usually driven by the size of the round (co-investors are invited to diversify the risk) and to "share the pipeline" (by giving access to its targets, the lead fund hopes to receive access from the co-investors to their targets).

7. What legal structure(s) are most commonly used as vehicles for venture capital funds?

Most venture capital (VC) funds active in Russia are structured as limited partnerships in non-Russian, tax-efficient jurisdictions, with the Cayman Islands being the preferred jurisdiction. Other commonly used jurisdictions include:

- British Virgin Islands.
- Jersey.
- Guernsey.
- Singapore.
- Luxembourg.

Typically, but not always, the general partner is incorporated in the same jurisdiction as a limited partnership. A Russian company associated with the general partner typically acts as a management company or as an investor adviser evaluating Russian investment targets.

Some VC funds are structured as companies in tax-efficient jurisdictions (mostly the BVI or Cyprus), in which case the relationship among the investors and the management is governed by a shareholders' agreement. Companies are typically used for funds with few investors and for high net-worth individuals' "family office" investments.

In 2015, the Russian Legislation on Controlled Foreign Companies became effective, permitting the Russian tax authorities to tax Russian tax residents on undistributed profits and capital gains realised by non-Russian companies controlled by them. This has significantly complicated the tax structuring of certain non-Russian funds for Russian taxpayers holding controlling stakes in such funds.

On 1 January 2012, Federal Law No 335-FZ, 28 November 2011 (Law on the Investment Partnership) introduced the "investment partnership", a Russian law vehicle allowing for features of a common law partnership that had not previously existed under Russian law, such as:

- Allocation of profit and losses and governance votes disproportionate to the invested amount.
- Rules governing capital contributions, exits, distributions and so on.

While not widely used by private investors, the investment partnership is the preferred structure of Russian state-sponsored limited partners, such as the Russian Venture Company and Rusnano.

The investment partnership remains an untested vehicle and has serious flaws, such as:

- Separate taxable "income baskets" for capital gains from different securities and assets.
- Inability to claim a 0% Russian capital gain exemption for sales of securities earlier contributed by a participant into the investment partnership.
- Joint and several liability of limited partners in certain circumstances.

INVESTMENT OBJECTIVES

8. What are the most common investment objectives of venture capital funds?

Venture capital funds' most common objective is to generate relatively high return on relatively high-risk investments in growth companies. The funds invest over an investment period (typically three to five years) and seek to achieve exits over the life of the fund (typically seven to ten years). The investment period and the life of the fund tend to be shorter for funds investing in earlier stage companies and in the IT sector, and longer for funds investing in later stage companies and in industrial products, biotech, pharmaceuticals and medical devices.

FUND REGULATION AND LICENSING

9. Do a venture capital fund's promoter, manager and principals require licences?

Activities of the manager (management company), specialised depository (custodian) and registrar (holder of the register of the owners), as well as activities of the independent appraisers and auditors on the territory of the Russian Federation require a relevant licence (for example in cases, where these activities relate to private equity funds operating as closed (mutual) unit investment funds under Russian law). Because most venture capital funds are structured in non-Russian jurisdictions, their activities outside of Russia do not fall under the Russian licensing requirements.

Some activities of a managing partner in the Russian investment partnership can fall under licensing requirements. Most managers operating in Russia conduct their activities without triggering the licensing requirements.

10. Are venture capital funds regulated as investment companies or otherwise and, if so, what are the consequences? Are there any exemptions?

The operations of closed (mutual) unit investment funds are heavily regulated under Russian law and must comply with various requirements established by the laws and regulations of the Bank of Russia. The units in such closed funds can be offered only to qualified investors and cannot be publicly advertised. Russian venture capital funds are rarely structured as such vehicles.

Securities of non-Russian companies or funds cannot be offered in any form in Russia to unqualified investors or to unlimited (unidentified) circles of persons, and cannot be publicly advertised, unless they are admitted to public placement and/or circulation in accordance with Russian law.

11. How is the relationship between investor and fund governed? What protections do investors in the fund typically seek?

The fund's constitutional documents govern the relationship between the investors and the fund. These documents are the:

- Limited partnership agreement (if the fund is structured as a limited partnership).
- Shareholders' agreement.

- Articles of association (if the fund is structured as a company) or investment partnership agreement (if the fund is structured as a Russian investment partnership).

These documents provide for distribution of the fund's profits (known as the "waterfall") and specify the amounts payable to the general partner and/or the manager such as:

- Management fees (2% to 2.5% of the invested amount is typical).
- Carried interest (20% of the profits is typical).
- Reimbursement of expenses.

These agreements usually contain the following investor protection provisions:

- Investment restrictions with respect to industry, investment amount and geography.
- Hurdle rate and other general partner performance goals.
- Fund governance and reporting provisions.
- Prohibitions on conflict of interest transactions.
- Provision for removal of fund managers with and without cause.
- Exclusivity provisions.
- Key person provisions.

Large investors may negotiate additional rights in side letters, such as investment committee veto rights.

INTERESTS IN INVESTEE COMPANIES AND SECURITIES REGULATION

12. What form of interest do venture capital funds take in an investee company? Are there any restrictions on direct investment in a company's equity securities by foreign venture capital funds? What regulations govern the offer and sale of securities in venture capital transactions?

Forms of interest

Venture capital (VC) investors usually invest in preferred equity. Investors can invest in ordinary shares (common stock) of very early stage companies (seed or angel round investments). Investors can also use convertible debt instruments, either for early-stage companies when unable to agree on the valuation or when making a bridge financing to the next round.

Russian law does not permit convertible debt. The concept of preferred equity is not recognised for Russian limited liability companies, the most used corporate entity form for Russian early-stage companies. Although Russian law recognises the concept of preferred shares for Russian joint stock companies, this mechanism is almost never used in VC investments. Until recently, preferred shares under Russian law provided their holders only with limited voting rights and with limited dividend and liquidation preferences. Amendments in July 2015 to the Russian Joint Stock Company Law permitted the creation of preferred shares in Russian non-public joint stock companies with broader "additional rights", including broader voting rights. Since joint stock companies are rarely used for early-stage companies and the mechanism of preferred shares remains vague and untested in courts, the use of Russian preferred shares in VC transactions is expected to remain limited, at least in the near future.

Except for very early stage Russian companies, where investors invest in ordinary equity, a typical structure would consist of a holding company in a jurisdiction that permits typical VC preferred equity and convertible debt, and one or more Russian wholly-owned operating subsidiaries. The choice of the holding company's jurisdiction is usually tax and future fundraising needs driven. Russian companies seeking future fundraisings in the US or planning to access the US market usually incorporate the holding company in Delaware. Otherwise, the jurisdictions of choice for holding companies are Cyprus and the British Virgin Islands.

Restrictions on direct investment

Various Russian laws regulate foreign investments in Russia. Typically, these laws either completely prohibit or require governmental consent for foreign investments exceeding a certain ownership threshold (including indirectly, on a look-through basis) in (or otherwise resulting in foreign control of) a Russian company engaged in "strategic business activities". The thresholds are industry-specific and can be lower if the investor is a foreign government or an entity owned by a foreign government.

The list of industries and strategic business activities is broad, and foreign investors should check the Russian target and its business activities against the list. In venture capital transactions, the foreign investments control issue most often becomes relevant for Russian mass media companies, broadcasting companies and IT companies holding software encryption licenses. Only Russian entity(ies) with foreign ownership of less than 20% may own a Russian mass media or broadcasting company. Foreign control of Russian mass media and broadcasting companies is prohibited. A Russian Special Governmental Commission's consent is required if a transaction would result in foreign ownership of over 50% in (or control of) a Russian company holding a software encryption license.

Securities regulation

Russian securities laws require registration, disclosure and filings for offers and sales of securities of Russian issuers to the general public or if such issuers are listed on the stock exchange. These requirements do not apply to most venture capital transactions, which are typically private issuances of securities by unlisted Russian issuers.

Russian securities laws also require registration of foreign securities offered or sold in Russia, including in a private sale. This issue is often relevant because many Russian investment transactions are structured with a non-Russian holding company (see Question 12). With registration of foreign securities being a relatively lengthy and costly process, all such venture capital transactions are structured as taking place outside of Russia (both offers and sales).

VALUING AND INVESTIGATING INVESTEE COMPANIES

13. How do venture capital funds value an investee company?

Due to limited operating history (if any), valuations are based on the potential market, strength of the founder team, revenue multiples and valuations of comparable companies. The investors give consideration to the remaining stake of the founders, taking into account the need for future financings, in an effort not to dilute the founders where they will lose motivation to drive the business. Valuations are typically set in US dollars.

14. What investigations do venture capital funds carry out on potential investee companies?

Investors review the business plan, projections, financials, and the management team of investee companies. For early-stage companies (seed and angel round), investors may limit their review to this. However, for later stage companies (round A and beyond), investors generally conduct more formal due diligence focusing on financial and legal issues. Financial due diligence generally consists of a review of the financial statements (management and/or audited). Legal due diligence generally focuses on tax, general corporate (including cap table structure), intellectual property, and employment matters.

LEGAL DOCUMENTATION

15. What are the principal legal documents used in a venture capital transaction?

The legal documents depend on the type of investment being made and the jurisdiction of incorporation of the holding company (see *Question 12*).

The principal document for an ordinary equity investment is the investment agreement, which can also be called the stock or share purchase agreement or the subscription agreement. This agreement governs the issuance and sale of the equity securities by the company, and their purchase by the investors, and contains the subscription price and other financial terms, conditions precedent to closing and the parties' representations, warranties and indemnities.

The principal documents for a convertible debt financing include:

- The note purchase agreement, which governs the sale of the convertible notes by the company, and their purchase by the investors, and contains the subscription price and other financial terms, conditions precedent to closing and the parties' representations, warranties and indemnities.
- The convertible note, which contains the provisions governing conversion of the principal and interest evidenced by the note into preferred equity (although sometimes these provision are found in the note purchase agreement).

The principal documents for a preferred stock financing with a Delaware (or other US) holding company include:

- The stock purchase agreement, which governs the issuance and sale of the preferred shares by the company, and their purchase by the investors, and contains the subscription price and other financial terms, conditions precedent to closing and the parties' representations, warranties and indemnities.
- The investors' rights agreement, which generally contains investors' rights to receive company information, to request demand and piggy-back registration, and to participate in future fundraising rounds.
- The right of first refusal and co-sale agreement, which provides the company and the investors with a right to purchase shares offered for sale by the founders (right of first refusal) and provides the investors with a right to participate alongside the founders and other major investors in sales of their shares (co-sale or tag-along rights).
- The voting agreement, which specifies how shareholders are to vote on certain matters, primarily with respect to the election of the directors, and may include the investors'

"drag-along" rights (the right to require the shareholders to vote to approve a sale or merger of the company).

- The amended and restated certificate of incorporation, the main constitutional document of the company, which provides for the rights, privileges and preferences of various series or classes of shares of the company (such as the liquidation preferences, anti-dilution protections, redemption rights and rights to dividends), as well as shareholder veto rights over certain corporate decisions (such as changes to the certificate of incorporation, mergers, liquidation and so on).

The principal documents for a preferred share financing with a non-US holding company (such as the BVI or Cyprus) include:

- The investment agreement (also called the share purchase agreement or subscription agreement) which governs the issuance and sale of the preferred shares by the company, their purchase by the investors, and contains the subscription price and other financial terms, conditions precedent to closing and the parties' representations, warranties and indemnities. This agreement is usually governed by English law.
- The shareholders' agreement, which generally contains the provisions found in the investors' rights agreement, the right of first refusal and co-sale agreement, the voting agreement and the amended and restated certificate of incorporation in a US-style preferred stock financing as described above. This agreement is usually governed by English law.
- The articles of association, which for the most part duplicate the operative provisions of the shareholders agreement.

Other agreements may also be used, such as intellectual property assignment agreements from the founders to the company and founder restrictive covenants (non-competition and non-solicitation).

The certificate of incorporation, articles of association, charter or an equivalent organisational document is filed with the governmental authorities and becomes public. There is typically no requirement to make the transaction documents public.

PROTECTION OF THE FUND AS INVESTOR

Contractual protections

16. What form of contractual protection does an investor receive on its investment in a company?

Investors in preferred equity generally have the following contractual protections:

- **Representations, warranties and indemnities.** The company, and sometimes the founders, make certain statements about the company and its business. If these statements are untrue, the company (and the founders if they made the warranties) must compensate the investors.
- **Liquidation preference.** On a liquidation event (including sales, mergers and other exits, as well as dissolutions), the investors are entitled to receive from the proceeds of the liquidation event their investment, sometimes with accrued interest or with a multiple, before the holders of more junior classes of shares receive anything.
- **Anti-dilution protection.** The investors' equity stake in the company will not be reduced as a result of a subsequent investment in the company at a reduced valuation.
- **Pre-emptive (or pro-rata) rights.** The investors have an opportunity to acquire their proportionate share of the

securities being issued by the company in a future fundraising at the same price as offered by the new investors. See *Question 22*.

- **Rights of first refusal.** The investors have an opportunity to acquire their proportionate share of the securities being sold to third parties by the founders or other major shareholders. See *Question 20*.
- **Tag-along (or co-sale) rights.** The investors have a right to include some or all of their shares in a purchase by a third party of another shareholder's shares. See *Question 20*.
- **Drag-along rights.** Investors holding a certain percentage of the company's shares can require all of the shareholders sell their shares on the same terms to a third party to whom the investors are selling their shares. See *Question 20*.
- **Redemption.** The investors have a right to require the company to repurchase their shares, often with accrued interest or with a multiple. This is not a typical investor protection in a Russian venture capital transaction.
- **Dividends.** The preferred equity can accrue dividends at a certain rate. Usually, these dividends are payable only on a liquidation event, which would include exits.
- **Veto rights.** Prior consent of all or some of the investors is required for the company to take certain actions. Investors usually have veto rights over strategic decisions, decisions that can reduce the value of the investor's stake in the company and decisions that can diminish the investor's rights. The veto rights do not usually extend to operational decisions. See *Question 19*.
- **Board representation.** The investors receive a right to appoint directors or observers to the company's board. The investor-appointed directors sometimes have additional veto rights.
- **Registration rights.** The investors have a right to require the company to register some or all of their shares in case of an IPO of the company's shares in the US.
- **Information rights.** The investors receive annual, quarterly and (occasionally) monthly updates on the financial status of the company, usually through provision of the company's management and audited accounts.

The contractual protections of investors in ordinary shares/common stock or in convertible debt are usually more limited than those of investors in preferred equity. Such investors usually have the benefit of representations and warranties, and may have veto rights.

Forms of equity interest

17. What form of equity interest does a fund commonly take (for example, preferred or ordinary shares)?

Venture capital investors usually invest in preferred equity. Investors can invest in ordinary shares (common stock) of very early stage companies (seed or angel round investments).

Preferred shares

18. What rights does a fund have in its capacity as a holder of preferred or preference shares?

A holder of preferred or preference shares has all the rights of an equity holder of the company and the rights created for its

series or class of preferred shares by the company's constitutional documents. See *Question 16*.

Management control

19. What rights are commonly used to give a fund a level of management control over the activities of an investee company?

Consent from some or all investors is typically required to effect certain matters that are strategic, can reduce the value of the investor's stake in the company or can adversely affect the investor's rights. The following is a list of matters that typically require investor approval:

- The business plan and budget.
- Changes in the company's business.
- A liquidation event (dissolution, liquidation, winding-up, bankruptcy, IPO, merger or sale of the company or substantially all of the company's assets).
- Changes to the constitutional documents that adversely affect investors, including changes to the rights attaching to the class or series of shares held by the investors.
- Creation of a series or a class of shares senior to the shares held by investors.
- Transactions exceeding a certain monetary threshold and transactions under which the company effectively guarantees obligations of others (pledges, guarantees, indemnities and so on).
- Acquisition of other businesses or companies.
- Equity incentive compensation plans.
- Distribution of dividends.
- Senior management compensation.
- The company's auditors and accounting policies.
- Conflict of interest and other related transactions between the company and its shareholders, officers or directors.
- Formal dispute resolution proceedings.

Investors usually do not have control over operational decision-making by the company. Although board representation (as directors or observers) is typical, investor-appointed directors usually do not have veto or decision-making rights with respect to operational matters. Some investors, while having a right to appoint a director, appoint only an observer to avoid issues and liability associated with directorship and directors' duties.

Share transfer restrictions

20. What restrictions on the transfer of shares by shareholders are commonly contained in the investment documentation or the company's organisational documents?

Investment documentation typically contains the following restrictions on transfer of shares:

- **Founder lock-up.** Some investors prohibit the key founders from transferring their shares during a certain period (usually two to three years) from the date of the investment, with limited exceptions. The investors strive to achieve a

balance between the founder having "skin in the game" and liquidity to benefit by the company's success.

- **IPO lock up.** Shareholders are usually subject to transfer restrictions in connection with an IPO.
- **Right of first refusal.** The investors have an opportunity to acquire their proportionate share of the shares being sold by the founders or other major shareholders on the terms being offered by the prospective purchaser. This right allows the investors to control the composition of the company's shareholders and to increase its stake in the company if desired. In transactions with a Delaware holding company (see *Question 12*), the company usually also has the right of first refusal, exercisable before any of the company's shareholders can exercise their rights.
- **Tag-along (or co-sale) right.** The investors have a right to include some or all of their shares in a purchase by a third party of another shareholder's shares, on the same terms as are offered by the purchaser to the other shareholder. This allows the investor to benefit by a liquidity event that might not otherwise be available to them. Effectively, this right gives the investors an opportunity to be involved in negotiations of the potential sale transaction.
- **Drag-along right.** Investors holding a certain percentage of the company's shares can require all of the shareholders sell their shares on the same terms. This right assures that minority shareholders do not block a liquidity event. To protect the ordinary shareholders, the drag-along provisions can allow exercise only after a certain date, if the purchase price reflects a valuation above a certain threshold, or with consent of the major ordinary shareholders.

These restrictions are typically duplicated in the company's organisational documents

21. What protections do the investors, as minority shareholders, have in relation to an exit by way of sale of the company?

Investors typically have the following protections:

- **Veto rights.** Certain corporate transactions cannot be effected without the investors' consent (see *Question 19*). These consent rights protect the investors from the company or the other shareholders taking decisions that can adversely affect the investors' stake.
- **Share transfer restrictions.** The investors benefit by the right of first refusal and tag-along rights, and often also by the drag-along rights. See *Question 20*.
- **Pre-emption (or pro-rata) rights.** See *Question 22*.

Pre-emption rights

22. Do investors typically require pre-emption rights in relation to any further issues of shares by an investee company?

Investors typically require pre-emption rights under which the investors have an opportunity to acquire their proportionate share of the securities issued by the company in future fundraisings at the same price as offered by the new investors. Such pre-emption rights allow the investors to maintain their percentage shareholding in the company.

Some transactions have a pay-to-play feature. The shareholding of an investor that fails to purchase its pro-rata

allocation in a future round is converted into a more junior class of shares. On conversion, the investor loses certain rights such as the liquidation preference or the anti-dilution protection. The extreme case is conversion into common/ordinary shares. The pay-to-play feature is often required by investors in a "down round" (a round at a valuation lower than that in the prior round) to force all investors to participate in the round.

Consents

23. What consents are required to approve the investment documentation?

Corporate approvals required for an investment depend on the holding company's jurisdiction. See *Question 12*.

For Delaware corporations, the shareholders and the board of directors must generally approve:

- Amendments to the certificate of incorporation.
- Amendments to the bye-laws.
- Share option plans and option pools.
- The transaction documentation (by the shareholder only if they have an applicable veto right, see *Question 19*).

Shareholder approval can be required to approve transactions between the corporation and its officers and/or directors, and some other transactions involving conflicts of interests. If the shareholders are waiving their pre-emption rights (see *Question 22*) or price-based anti-dilution protection in a down round (see *Question 16*), separate waivers and consents are required.

For Cyprus or a British Virgin Islands companies, the following approvals are generally required:

- The board of directors generally approves the:
 - transaction documents;
 - allotment and issuance of shares; and
 - new articles of association.
- The shareholders generally:
 - approve the new articles of association (by at least 75% of the shareholders in case of Cyprus companies);
 - give the board of directors authority to allot and issue new shares (by at least 75% of the shareholders in case of Cyprus companies);
 - waive pre-emption rights (see *Question 22*) or, if applicable, price-based anti-dilution protection in a down round (see *Question 16*); and
 - approve the transaction documents (if the shareholders have an applicable veto right, see *Question 19*).

For investments directly into a Russian company, the following approvals are generally required:

- The board of directors and/or shareholders generally approve the:
 - new charter;
 - issuance of equity interests; and
 - transaction documents, if approval is mandatory under Russian law or under the company's constitutional documents.

- The shareholders generally must waive the pre-emption rights in connection with issuance or transfer of equity interests.

Russian law requires an approval by at least 75% of the shareholders to amend the charter and/or to issue equity securities, with certain charter amendments changing rights among the shareholders requiring a unanimous shareholder approval.

COSTS

24. Who covers the costs of the venture capital funds?

Typically, the company reimburses the investor for its out-of-pocket expenses (primarily, the investor's attorneys' and accountants' fees) incurred in connection with due diligence and negotiation and preparation of the transaction documents and closing of the transaction. The reimbursement amount is usually capped.

FOUNDER AND EMPLOYEE INCENTIVISATION

25. In what ways are founders and employees incentivised? What are the resulting tax considerations?

Incentives

Typical founders' and employees' incentive tools include:

- Share options.
- Restricted shares.
- Share appreciation rights (or phantom options).
- Cash bonuses.

Share options are rights to acquire a certain number of the company's shares at a set price (strike price). Restricted shares (or restricted stock) are already issued shares that the company has a right to purchase from the shareholder, usually at the same price the shares were issued to the shareholder. Both share options and restricted shares are intended to motivate the founders, management, and employees to build shareholders' value by aligning their interests with the interests of the shareholders.

Share options and restricted shares are also a retention tool. They generally vest over time, thereby incentivising the holder to remain with the company. For share options, vesting means the share options becoming exercisable, giving the holder a right to purchase the shares subject to the option. For restricted shares, vesting means the shares becoming free of the company's right to purchase them. The typical vesting is four-year monthly vesting with a one-year cliff. This means that 25% of the options or shares

vest on the first anniversary of the award, and the remaining options vest during the remaining three years in equal monthly instalments.

Vesting is usually accelerated (all or a portion of the shares vest ahead of the schedule) on either a:

- Liquidity event (single trigger acceleration).
- Liquidity event and the option or restricted shareholder relationship with the company terminating because of that liquidity event (double trigger acceleration).

Share options and restricted shares are usually administered under a plan approved by the board of directors and the shareholders.

Share appreciation rights or phantom shares are common for Russian companies. These are effectively cash bonus payments calculated as if the recipient held restricted shares, without any right to actual shares. These plans are used when the employer prefers not to issue actual equity to employees, but wishes to incentivise and compensate employees in a manner similar to the issuance of equity to them. The term "phantom" is used because the plan is intended to simulate the economic returns the employee would have received if he had owned actual equity in the employer, but without giving the employees the legal rights associated with equity ownership. Until recently, these were the primary forms of management "equity" compensation because the Russian tax consequences of actual share options had been unclear under Russian law and because implementation of share option or restricted share awards under Russian law is cumbersome.

Some Russian companies incentivise the founders, the management and the employees with cash bonuses; although these are neither common nor significant as emerging companies usually try to conserve cash.

Tax

Until recently, taxation of equity compensation under Russian law was significantly uncertain. This uncertainty led to companies implementing share appreciation rights or phantom option plans instead. In 2012, the Russian tax authorities clarified that a recipient is generally not taxed at the grant of an option or restricted share award. On the exercise of a share option or at the vesting of restricted shares, the individual taxpayer is taxed at a 13% tax rate on any realised gain. Cash bonuses and dividends of Russian individuals are generally taxed at 13%. If dividends are received from a non-Russian company, foreign withholding tax may apply, which, however, can be credited against the Russian income tax under the applicable double-tax treaty.

The specific employee, not the employer, is responsible for reporting and paying all taxes incurred in connection with the equity compensation plan. If certain conditions are met, equity compensation payments are not subject to Russian insurance contributions in Russia.

26. What protections do the investors typically seek to ensure the long-term commitment of the founders to the venture?

Investors usually encourage the founders' commitment to the venture through incentives (*see Question 25*) and punitive measures. Punitive measures usually divest the founder of his stake in the company on leaving. Restricted founders shares are used for holding companies that are Delaware corporations, and leaver provisions are used for British Virgin Islands and Cyprus holding companies.

Founder restricted shares mean that, if the founder leaves the venture, the company has a right to purchase the founders' shares in the company at the price the founder paid for the shares at their issuance (usually nominal). Founder restricted shares are otherwise similar to restricted shares (*see Question 25*), having vesting and acceleration. The typical vesting period is two to three years.

Leaver provisions are usually found in the articles of incorporation. They usually provide that on the founder leaving the venture (becoming a "leaver"), the founder's shares either automatically convert into a class of shares redeemable by the company or the company's right to purchase the founder's shares comes into operation. The provisions usually distinguish between bad and good leavers.

A bad leaver is generally a founder who quits the venture voluntarily or is terminated "for cause" (breach of obligations, criminal conduct or wilful misconduct). A good leaver is generally a founder whom the company terminates without cause or who leaves for "good cause" (health reasons, death, with the permission of the board of directors and so on). The conversion or purchase price for bad leaver's shares is usually nominal, while the conversion or purchase price for good leaver's share is their fair market value. The leaver provisions usually have vesting schedules and/or expiration dates.

Various restrictive covenants prohibiting the founder from competing with the company or to soliciting employees are commonly implemented either as stand-alone agreements or as part of the shareholders' agreement. Non-compete and non-solicitations agreements are unenforceable in Russia and, if entered into, are done so under non-Russian law with a non-Russian arbitration venue. Even so, the enforceability of a foreign arbitration award in Russia is uncertain.

EXIT STRATEGIES

27. What forms of exit are typically used to realise a venture capital fund's investment in an unsuccessful company? What are the relative advantages and disadvantages of each?

Investors generally seek to minimise losses in an unsuccessful investment through:

- Sale of the company.
- Sale of the company's assets and distribution of proceeds through dividend or liquidation.
- Liquidation of the company.

The investor generally selects the option that maximises its proceeds.

28. What forms of exit are typically used to realise a venture capital fund's investment in a successful company? What are the relative advantages and disadvantages of each?

The two main exits in connection with a successful investment are a sale of the company and an IPO. Most shareholders

seeking liquidity pursue a dual-track process and market the company for sale while preparing for an IPO. In Russia, although the number of exits has been growing (see *Question 1*), exits are relatively few. To compensate for the relatively few exits, investors in earlier rounds sell all or a part of their stake to investors in later rounds.

An IPO is beneficial to investors if the company sustains share price growth after an IPO, as the investors would be subject to a lock up immediately after an IPO. The IPO process is lengthy and expensive. However, if the company can perform at a public company level, the potential returns to investors can be greater than on a sale.

A sale is usually a much shorter and less expensive process than an IPO. The investors can obtain liquidity relatively quickly, but may remain subject to purchase price adjustment, warranties claims and so on that may reduce their return.

Due to a relative scarcity of exits, the practice in the Russian market is for earlier round investors to sell all or part of their stake to later round investors. Often the founders simultaneously sell a part of their stake. This is often accomplished by the company selling the most senior class of shares to the later round investors and using the proceeds to repurchase or redeem shares of earlier round investors. This provides liquidity to the earlier round investors while the later round investors receive the most senior class of shares, thereby providing liquidity without a true liquidity event.

29. How can this exit strategy be built into the investment?

Exit strategies are usually incorporated in the transaction documents through drag-along (see *Question 20*) and registration rights provisions (see *Question 16*).

The transaction documents often provide, with various levels of detail, a general co-operation obligation to seek and effect an exit. Although relatively common, these provisions are not legally enforceable.

ONLINE RESOURCES

W www.consultant.ru

Description. Online database containing Russian law and court practice. It contains official information which is generally up-to-date. Access to certain documents is limited subject to fee payment.

Practical Law Contributor profiles



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Areas of practice. Head of Emerging Growth Companies and Venture Capital: Russia and CIS; Corporate finance; mergers and acquisitions; venture capital; private equity; technology.

Non-professional qualifications. University of Washington School of Law, JD, Order of the Coif, 1999; Whitman College, BA, Economics, summa cum laude and Phi Beta Kappa, 1996; Ural State Technical University, BS, Economics, 1992; guest lecturer, Moscow State University School of Law and at the Skolkovo Moscow School of Management (MBA programme and Startup Academy)

Recent transactions

- Advised Profi.ru in connection with several fundraising rounds totalling over US\$25 million from Intel Capital, Baring Vostok, and Frontier Ventures.
- Advised Goldman Sachs in connection with investment in OneTwoTrip, a leading Russian language online travel agency.
- Advised I2BF Global Ventures, a global technology investment fund, in connection with a US\$20 million Series B investment in Dauria Aerospace, a global satellite technology company.
- Advised Russian Ministry of Communications in connection with its venture capital investments programme.
- Advised Plastic Logic, a leader in plastic semiconductors, in a US\$250+ million fundraising.

Languages. English and Russian

Professional associations/memberships. American Bar Association; Washington State Bar Association; Russian Venture Company investment committee; Washington Law Review, editor, 1997 to 1999