Russian financial regulation over the past few years has been marked by some fundamental shifts that have finally rewarded the industry’s efforts to overhaul the regulatory framework for OTC derivatives, including the introduction of close-out netting. This article describes legal and regulatory reforms providing for Russia’s OTC derivatives markets.
For over a decade, Russia’s over-the-counter (OTC) derivatives markets were rather subdued. A slew of court decisions in the wake of the 1998 financial meltdown denied enforcement to non-deliverable foreign exchange forward transactions on the basis of the anti-gaming provisions of Article 1062 of the Russian Civil Code.

But as the country gradually overcame the consequences of the 1998 crisis the financial sector began to emerge from the doldrums to cater for the ever-increasing needs of the economy. The financial industry’s lobbying efforts solidified around the need to lay down the statutory foundation for new types of financial products and services, including OTC derivatives.

The principal milestones of the regulatory change over the last few years include:

- amending Civil Code Article 1062 to provide a safe harbour from the anti-gaming statute to eligible derivative transactions
- amending Federal Law No. 39-FZ (the Securities Market Act) to introduce a definition of financial derivatives
After the 1998 financial crisis, court decisions denied enforcement to non-deliverable foreign exchange forward transactions on the basis of the anti-gaming provisions of the Russian Civil Code.

- amending the Securities Market Act to allow for multiple repurchase, OTC derivative and certain other transactions to be governed by a single master agreement
- amending the insolvency legislation to allow close-out netting of eligible repurchase, derivative and certain other transactions governed by a single master agreement
- amending the Tax Code to improve the tax treatment of OTC derivative transactions, both by the dealers and the end-users
- developing, through industry efforts, a standard form of a master agreements to govern: (i) domestic OTC derivative transactions and (ii) repo transactions
- amending the currency control legislation to allow onshore settlement in foreign currency of derivative transactions.

While all of the above measures will influence the shape and pace of growth of the domestic and cross-border financial markets, this article focuses on close-out netting of OTC derivative transactions.

**Exempting eligible transactions from the Insolvency Act**

The Insolvency Act (Federal Law No. 127-FZ) was amended on 7 February 2011 (by Federal Law No. 8) in order to create a special insolvency regime that applies to financial transactions. The regime exempts eligible transactions from some of the restrictive provisions of the Insolvency Act.

The Insolvency Act (as amended) provides that

"...obligations arising out of contracts governed by a master agreement (single agreement) which corresponds to the model terms envisaged by the Securities Market Act (hereinafter financial contracts) shall terminate in accordance with the procedure envisaged by said master agreement (single agreement) (...) Such termination shall give rise to a monetary obligation the amount of which is to be determined in accordance with the procedure envisaged by the master agreement (..)"

**Eligibility requirements**

*Model terms of a contract.* The Insolvency Act requires the master agreement to correspond to the model terms envisaged by the Securities Market Act, which implies that an eligible master agreement that governs local market transactions must incorporate the model terms of a contract developed by a self-regulatory organisation of professional market participants (an SRO).

One set of such model terms has already been developed by the National Stock Market Association (NFA) for domestic repurchase agreements and approved by the Federal Financial Market Service (FFMS). The other was jointly developed by the National Association of Professional Market Participants (NAUFOR), the Association of Russian Banks (ARB) and the National Foreign Exchange Association (NFEA) to govern domestic OTC derivative and, optionally, certain spot transactions.

The NAUFOR/ARB/NFEA model terms were published in 2009 and have already gained a substantial market share in terms of the volume of OTC derivative transactions entered into in the local market. A revised version has been prepared to accommodate the new requirements of the Insolvency Act and ensure netting eligibility of the model terms under the new regime.

The model terms must contain grounds for an early termination of outstanding transactions, which includes the occurrence of a specified event of default and the procedure for determining the amount of monies or other assets payable or deliverable in connection with such early termination.

Special requirements apply to an early termination triggered by a bankruptcy event in relation to a party. If triggered by a bankruptcy event, the close-out mechanics and the determination of an early termination amount must envisage that:

- all outstanding transactions be terminated as of the date to be determined in accordance with the master agreement but no later than the date immediately preceding the date on which (i) the insolvent party is recognised by a court to be bankrupt and ordered to be...
The Securities Market Act expressly accommodates the needs of the cross-border market by allowing forms of master agreements developed by international associations to be used to document derivative and repo transactions, provided that such forms have been approved by the FFMS. The FFMS is expected to approve the 1992 ISDA Master Agreement (Multicurrency – Cross-Border) and the 2002 ISDA Master Agreement, provided that the Second Method applies – that is, that the non-defaulting party is not excused from paying the early termination amount upon termination of the transactions if such amount were due to the defaulting party. It is also expected that the 1995, 2000 and 2011 versions of the Global Master Repurchase Agreement (GMRA) will be approved for the cross-border repo market.

Eligible transaction types. Under the Insolvency Act, contracts entered into under a master agreement (single contract) that comply with approved model terms of a contract are treated as “financial contracts” eligible for close-out netting. Under the Securities Market Act, an approved master agreement (single contract) may govern financial derivatives, repo transactions and other contracts regarding foreign exchange or securities. A financial derivative is defined as a contract that provides for one or more of the following:

(i) an obligation of a party or the parties to make a single or periodic payments of monies dependent on a change in the price of commodities or securities, the exchange rate of a foreign currency, an interest rate, a rate of inflation, indicators calculated by reference to the prices of financial derivative instruments, official statistical data, physical, chemical and/or biological characteristics of the environment, the occurrence of an event evidencing a failure to perform or properly to perform an obligation by a legal entity (or a group of legal entities), a sovereign state or a municipal entity (except suretyship or insurance contracts) or any other circumstance which is uncertain to occur as may be specified by federal statute or [the FFMS] regulation…;

(ii) an obligation of a party or the parties, upon demand by the other party and on the terms specified in the contract, to buy or sell securities, foreign currency or a commodity or to enter into a financial derivative instrument; or

(iii) an obligation of a party to transfer securities, foreign currency or a commodity to the ownership of the other party and an obligation of the other party to accept and to pay for such assets not earlier than on the third day following the date of the contract, provided that such contract expressly states that it constitutes a financial derivative instrument.

The specific types of financial derivative instruments are set out in the Regulation on the Types of Financial Derivative Instruments enacted by the FFMS Order No. 10-13/pz-n and include various forward, option and swap transactions.

Financial derivatives therefore include (i) cash-settled or deliverable transactions with payouts linked to an eligible underlying asset, (ii) put and call options on foreign exchange, securities and commodities, as well as swaptions, and (iii) deliverable forward-settling transactions that the parties have expressly chosen to have treated as financial derivative instruments.
Although the intention of the draftsmen was to apply the netting regime primarily to repos and derivatives, as well as similar transactions with a shorter settlement cycle (such as spot foreign exchange or cash equity transactions), the broad reference to “other types of transactions, the object of which is foreign exchange or securities” introduces some uncertainty as to how far the scope of the Master Agreement can be stretched to absorb non-derivative transactions without compromising its eligibility for close-out netting under the Insolvency Act. Time will tell.

Additional eligibility requirements

As well as a Master Agreement needing to comply with approved model terms of a contract, the netting regime imposes certain additional eligibility requirements.

Timing of the transactions. The netting regime applies to transactions which pre-date the appointment by a regulator of a temporary administration (external management) to a financial organisation, an introduction of any of the insolvency procedures set out in the Insolvency Act or the revocation of a banking licence, whichever is applicable and occurs earlier.

Parties to the master agreement. One of the parties to the master agreement must be an eligible counterparty. Eligible counterparties for these purposes include:

- the Bank of Russia
- a regulated Russian bank or investment firm
- a foreign-regulated bank or investment firm incorporated and authorised in a member state of the Organisation for Economic Co-operation and Development, Financial Action Task Force or Micro, Small and Medium Size Enterprise
- a central bank of a member state of the OECD, FATF or MONEYVAL
- an international financial organisation.

The other party to the master agreement may be any legal entity (including a foreign entity incorporated in a member state of the OECD, FATF or MONEYVAL), beneficial holders of units in mutual funds, the Russian Federation, its constituent entities or municipalities, any member state of the OECD, FATF or MONEYVAL or their subdivisions. The Insolvency Act thus ostensibly disallows close-out netting of transactions where one of the parties is a natural person which reflects a long-standing policy of discouraging derivatives trading with individuals.

Registration with a trade data repository.

Under the Securities Market Act, netting-eligible transactions must be recorded in a specialised trade data repository operated by an SRO or a stock exchange. The Moscow Interbank Stock Exchange (MICEX) is expected to operate the repository. The procedure for recording the trade data will be set out in a regulation to be put out by the FFMS.6

The Insolvency Act makes registration with a repository a pre-requisite for a transaction to be eligible for close-out netting. The set-up of the repository has turned out to be a more challenging task than originally expected. Much like the debate over the details of the registration requirements unfolding in other jurisdictions, the Russian regulator and MICEX (currently the sole candidate for the operator of a nationwide repository) are doing their best to work out the format for trade reports for various types of reportable transactions as well as the model for the optimal allocation of data aggregation and processing functions among the repository, the FFMS and the Bank of Russia. As a result, it is not yet known when the new registration system will be implemented but it will probably be several more months before it becomes operational. The effective date of the close-out netting regime is accordingly put on hold.

Net obligation amount.

The early termination amount (referred to as a “net obligation”) must be a monetary obligation determined in accordance with the model terms of a contract as described above. It is worth noting that, when entering into a cross-border master agreement such as an ISDA Master Agreement or a GMRA, one needs to consider carefully whether any of its provisions need to be amended to ensure compliance with the specific requirements of the Insolvency Act applicable to the eligible model terms of a contract.
Focus section: Developing capital markets

Close-out netting legislation incorporated into the Insolvency Act came into effect on 11 August 2011

Credit Support Annex

The close-out netting legislation is designed to serve a two-fold objective. First, it reduces the net exposure of the parties to one another under a master agreement. Second, it allows the parties to enter into a title-transfer credit support annex to cover the residual net exposure. The structure of the Russian derivatives market, which is characterised by relatively low liquidity in the inter-dealer market and a largely unidirectional exposure in the client-facing sector, makes the second aspect of netting particularly important. The lack of explicit statutory protection for title-transfer security arrangements has caused a fair amount of debate among commentators as to the enforceability of title-transfer credit support annexes to the master agreements.

Since its publication by NAUFOR, ARB and NFEA in 2009, the Russian variation margin agreement (modelled on the English law ISDA Credit Support Annex) has found only a limited use in the market. The main reason is the uncertainty around its enforceability in its own right (the recharacterisation risk), as well as the lack of the statutory protection of close-out netting. Without such protection any attempt to terminate outstanding transactions and factor the margin amount into the determination of the early termination amount remains at risk of being avoided by the bankruptcy administrator.

The Russian law agreement for the transfer of variation margin according to its terms constitutes a transaction. The margin amount is periodically calculated by reference to the transferee’s exposure (credit risk) to the transferor. The transferee’s credit risk is calculated on the basis of the close-out values of the rest of the transactions under the master agreement. The close-out value of a transaction is the cost of a replacement transaction in the market as of the relevant valuation date. If the close-out value of the transactions governed by the master agreement (excluding the margin agreement) changes, the transferee or the transferor has an obligation to transfer a margin amount to the other party.

As part of revising the Russian law master agreement for OTC derivative transactions, the experts of NAUFOR, ARB and NFEA have also revisited the basic tenet of the margin agreement. Under the new proposal, rather than linking the margin amount to the amount of the transferee’s counterparty credit risk, the new form will define the margin amount as an amount payable by the parties dependent on the change in the aggregate value of the other transactions governed by the master agreement. Because the parties’ obligation to make payments under the margin agreement depends on a change in the price of financial derivatives (that is, the aggregate cost of replacement transactions), the margin agreement should itself fall within the statutory definition of a financial derivative (as long as certain simple rules are observed) and as such become eligible for close-out netting. The FFMS is also considering expanding its regulation setting out the types of financial derivative instruments to explicitly include credit support annexes.

Effective date

On the face of it, the close-out netting legislation incorporated into the Insolvency Act came into effect on 11 August 2011. In practice, however, the benefits of close-out netting at the time of writing are not yet available to the market because some of the pre-requisites for the relevant legislation to become operational are still missing.

Most notably, while the implementing regulations that failed to be published in time for the 11 August 2011 effective date have since been enacted, the trade data repository will take a while to be set up and tested.

Migration of heritage transactions

NAUFOR, ARB and NFEA have developed a form of amendment to the current version of the master agreement that is designed to qualify existing transactions for the benefits of the close-out netting regime once such a regime gains traction.

Conclusion

Financial derivatives have been known in the Russian market for quite some time. Their enforcement history, however, is controversial. The new close-out netting regime will no doubt leave a number of questions unanswered until clarified by further regulation.
The new close-out netting regime will leave a number of questions unanswered until clarified by further implementing regulations or court practice.

That said, however, the importance of seeing the current netting legislation come into effect is difficult to overstate as it provides the necessary, even if not exhaustive, guidance as to the basic parameters of the new netting regime, and encourages market growth and liquidity while significantly reducing systemic risks in the Russian financial sector. All the benefits, as well as occasional mishaps, of the modern derivatives markets are yet to be learned by the Russian market, but with the enactment of the netting legislation the country is making a qualitative leap in the right direction.
Notes

1 Vladimir was the lead draftsman of the Russian standard documentation for local OTC derivative transactions, the components of which include: the model terms of a contract, a form of the master agreement, product annexes for derivative transactions with foreign exchange, interest rate, equities and fixed income securities as an underlying asset as well as the standard variation margin agreement form. He is adviser to the Chairman of the Executive Board of NAUFOR and a member of the joint expert panel of NAUFOR, ARB and NFEA, which was charged with revising the current version of the documentation to accommodate the requirements of the new close-out netting regime.

2 “Model terms of a contract” is a term of art under Russian law which refers to a set of published standardised contractual provisions incorporated by reference into an agreement between the contracting parties. The Russian forms of a master agreement for repurchase transactions and the OTC derivative transactions developed respectively by the National Stock Market Association and jointly by the National Association of Professional Market Participants, the Association of Russian Banks and the National Foreign Exchange Association both rely on the model terms structure. In reference to the ISDA architecture, the Russian model terms would be analogous to the form Master Agreement while the Russian master agreement would be analogous to the Schedule, except that, unlike the ISDA Master Agreement, the model terms under the Russian structure are incorporated by reference rather than executed.

3 “Lost benefit” is a term of art that refers to damages which, along with “direct damages”, are allowed to be claimed by the aggrieved party for a breach of covenant. At a risk of oversimplification, direct damages are damages the aggrieved party has suffered directly from the loss of bargain under the breached contract. Lost benefit refers to the loss of bargain the aggrieved party has suffered under other contracts which, as a result of the defaulting party’s breach, can no longer be realised.

4 Unlike the repo market, the securities lending market in Russia, both domestic and cross-border, is underdeveloped primarily over enforceability concerns. It is, therefore, unclear whether the International Securities Lending Association form will be on the approved list of foreign master agreements.

5 The definition of this type of financial derivative is somewhat confusing in that it provides that such contracts may also provide for the delivery of securities, foreign exchange or a commodity or for entering into another financial derivative transaction. This appears to overlap with the reference in (iii) to deliverable instruments which, however, imposes two additional pre-requisites for the relevant transactions to be treated as derivatives, that is, a T+3 settlement cycle and an indication that it is a financial derivative. This confusion is a result of an unfortunate drafting of clause (i) which was originally intended to cover only cash-settlement instruments while allowing for transfers of margin in the form of securities, foreign exchange and commodities. It now appears to include deliverable derivative transactions with a payout linked to a variable indicator and as such are different from vanilla forward purchase and sale transactions captured by clause (iii).

6 A draft regulation was posted for comments on the FFMS web site on 14 November 2011.

Author

Vladimir Khrenov
Partner, Monastyrsky, Zyuba, Stepanov and Partners
www.mzs.ru
Tel: + 7 (495) 231 4222
Fax: + 7 (495) 231 4223
Email: moscow@mzs.ru
Monastyrsky, Zyuba, Stepanov and Partners
3/1 Novinski Boulevard
Moscow 121099
Russia