

# Netting in Russia: Light at the End of the Tunnel

## INTRODUCTION

This client briefing discusses the proposed amendments to the Russian Securities Market Law, the Insolvency (Bankruptcy) Law and the Credit Organisations Insolvency (Bankruptcy) Law that are currently being considered by the State Duma of the Russian Federation (the lower chamber of the Russian Parliament).

While we do not generally issue client briefings on draft legislation, the importance and the possible impact of this draft law on the Russian financial markets warranted an earlier circulation.

Note that the discussion below is based on the draft legislation that was adopted by the State Duma in the third reading.

## BACKGROUND

As Russian law is not familiar with the concept of netting, Russian courts generally treat netting as a form of set-off (which is considered to be the nearest concept in Russian law) which allows matured homogenous obligations to be offset.

While in a non-insolvent default scenario, Russian courts recognise and enforce netting arrangements, Russian Insolvency Law expressly prohibit set-off (and, by extension, netting) following the revocation of a banking licence (for banks) or introduction of the supervision stage (*nablyudeniye*) (for corporates).

As a result, non-Russian market participants generally calculate their exposure under derivative and repo transactions with Russian counterparties on a gross basis, which had anything but a positive impact on the risk assessment of transactions with Russian counterparties and overall trading volumes.

There were a number of attempts to introduce netting legislation in Russia but previous versions of the draft legislation did not make it through the parliamentary Financial Markets Committee.

The current draft bill (which is being adopted as part of the push to establish an international financial centre in Moscow) was shrouded by secrecy with its copies being distributed on a need-to-know basis and became the subject of a heated debate as there were concerns that the proposed legislation would affect

### Key Issues

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#### The Amendments

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- Eligible Counterparties
- Eligible Documentation
- Registration
- Insolvency Treatment

#### Certain Salient Issues

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the rights of retail depositors. Although the current situation is not entirely clear, we understand that these concerns have now been dealt with and the draft bill should progress smoothly.

## THE AMENDMENTS

### *Eligible Transactions*

Under the proposed amendments, close-out netting arrangements will be recognised and enforced in the context of derivative transactions, repos as well as FX and securities transactions documented under eligible master agreements (see "*Eligible Documentation*" below).

In order for close-out netting to be enforceable, transactions must be entered into prior to the introduction of insolvency proceedings (with respect to non-banks) or appointment of temporary administration or revocation of banking licence (for banks).

### *Eligible Counterparties*

The list of eligible counterparties include:

- (1) *Financial institutions*
  - (a) Russian banks and professional securities market participants (brokers, dealers, custodians, etc.) (PMPs);
  - (b) Central Bank of the Russian Federation;
  - (c) non-Russian banks and PMPs incorporated in an OECD/FATF/MONEYVAL jurisdiction;
  - (d) supranational financial organisations (IFC, EBRD, World Bank, etc.); and
  - (e) non-Russian central (national) banks;
- (2) *Other Counterparties*
  - (a) other Russian entities;

- (b) Russian Federation, regions (so-called 'subject of the Russian Federation') and municipalities;
- (c) holders of mutual funds;
- (d) foreign states; regions and municipalities; and
- (e) other non-Russian entities;

**PROVIDED THAT** at least one party to the contract is an entity listed in (1) above.

### *Eligible Documentation*

Eligible master agreements include:

#### (1) *Domestic Documentation*

Domestic master agreements must conform to the 'model provisions' developed and approved by a self-regulated organisation (SRO) and vetted by the Federal Financial Markets Service ("FSFM"). Such master agreements must provide for the procedure of termination of transactions upon the occurrence of an event of default and calculation and payment of the close-out amount. If insolvency (bankruptcy) occurs, an eligible master agreement must provide for the termination of all transactions concluded under the master agreement on the earlier of: (a) the date provided for in the master agreement; and (b) the date preceding the commencement of insolvency proceedings or, with respect to banks, revocation of the banking licence. The close-out amount calculated following the insolvency (bankruptcy) event cannot include the amount of fines and penalties and compensation of lost profit.

Eligible master agreements must also contain an express statement to the fact that their terms conform to the above termination and close-out amount calculation procedure as well as to their general adherence to 'model provisions'.

In practical terms, we understand that it is the intention of the regulator that the derivatives documentation approved by ARB, NAUFOR

and NFEA in 2009 (“**2009 Documentation**”) will be an eligible master agreement.

## (2) *Cross-border Documentation*

The amendments also extend netting recognition and enforceability protection to repos, derivative transactions and FX and securities transactions provided that they are entered into under master agreements developed by international industry bodies included in the list to be approved by the FSFM.

While the secondary legislation is yet to be adopted, from our discussions with the FSFM, we understand that it is their intention to include ISDA and ISMA in that list thus making ISDA Master Agreement and Global Master Repurchase Agreement eligible for netting.

### **Registration**

As a further requirement for the recognition of netting arrangements, the amendments require that the parties provide information on concluded transactions to a repository that will, in turn, report to the FSFM.

While it was initially suggested that this role for OTC transactions will be allocated to one of the Russian exchanges, it is now likely that the function will be performed by the Russian brokers' SRO, NAUFOR.

### **Insolvency Treatment**

The Insolvency (Bankruptcy) Law is clarified to state that the statutory prohibition on set-off would not extend to the calculation of the close-out amount under eligible transactions between eligible counterparties registered with the repository and that such prohibition would only apply to offsetting the close-out amount against other obligations of the insolvent entity (thus effectively making Clause 6(f) of the ISDA Master Agreement unenforceable in insolvency).

The amendments also provide that the temporary (bankruptcy) administrator may refuse to perform all but not some transactions thus effectively prohibiting cherry-picking.

It also makes clear that claims for the payment of the close-out amount will rank *pari passu* with claims of other unsecured creditors.

### **CERTAIN SALIENT ISSUES**

The proposed amendments raise a number of issues. In particular:

- (a) **Eligibility of Transactions.** The netting regime would cover transactions between financial institutions and Russian corporates but would not apply to transactions between corporates (thus inhibiting the ability of corporates to hedge their exposure with their non-Russian parent companies) or transactions with individuals (which may have an impact on certain private banking transactions);
- (b) **Bespoke Documentation.** It is unclear whether netting under bespoke derivatives master agreements developed by market participants would be recognised and it is likely that the market will move towards a wider use of the 2009 Documentation. It is also not entirely clear whether transactions documented under long-form confirmations would enjoy the same netting treatment;
- (c) **Close-out Amount Calculation.** As noted above, in order for the close-out amount calculated as a result of the occurrence of a bankruptcy (insolvency event) to be recognised and enforced in insolvency, it cannot include the amount of fines and penalties and compensation of lost profit. As the 6(e) calculation (as well as the amount calculated under Section 6.10 of the Model Provisions) includes an element of default interest, it would be advisable to amend the relevant provisions to ensure compliance with the Insolvency (Bankruptcy) Law;
- (d) **Automatic Early Termination.** It is now clear that the automatic early termination provisions of the ISDA

Master Agreement, Global Master Repurchase Agreement and 2009 Documentation will be enforceable in Russia. Moreover, in order to ensure compliance with the Russian eligibility criteria, parties will be required to opt for AET in their documentation;

- (e) **Reporting.** The reporting requirements provided for by the draft bill continue to be the subject of debate among the market participants as the scope and frequency of reporting is yet to be established by the secondary legislation. Some have expressed concern that any potential requirement to disclose the detailed terms of the concluded transactions (that often contain proprietary economic models) would adversely affect the Russian derivatives market. However, the wording of the amendments (and, in particular, those made to the Insolvency (Bankruptcy) Law) suggest that reporting would be limited to the fact of the conclusion of the relevant transaction as well as its identifier (such as a reference number); and

- (f) **Collateral Transfers.** The amendments do not expressly deal with the netting eligibility of collateral transfers under credit support documentation. It would appear logical that as collateral transfers under the ISDA CSA documentation and 2009 Documentation are treated as Transactions, they should qualify for netting purposes provided that they are registered with the repository. Having said that, it is not possible to exclude the risk of an alternative interpretation.

## NEXT STEPS

Having been approved by the State Duma in three readings, the draft bill will now be passed for the approval of the Federation Council (the upper chamber of the Russian Parliament) and will then need to be signed by the President of the Russian Federation. It is difficult to venture a guess as to the timing but we continue to monitor the situation closely and will provide updates on the developments.

If and when promulgated, the amendments will become effective in six months from the date of their official publication and are subject to the adoption of secondary legislation (including regulations setting out lists of eligible master agreements and foreign industry bodies as well as those on the details of reporting and registration requirements).

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