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Developments in Derivatives Regulation

The Federal Service on Financial Markets ("FSFM") introduced an order "On approval of the Regulation on Types of Derivative Financial Instruments" (the "**Regulation**")¹.

The Regulation was issued in compliance with the Federal Law "On Securities Market" ("**Securities Markets Law**")², authorizing the FSFM to determine the types of derivative instruments.

Types of Derivatives

According to this Regulation, the FSFM recognizes the following instruments and provides for their definition:

- a. options;
- b. futures;
- c. forwards entered into on the stock exchange;
- d. OTC forwards; and
- e. swaps.

The Regulation contains the list of underlying assets that are consistent with the definition of a "derivative financial instrument" in the recently updated Securities Markets Law³.

The Regulation states that derivative financial instruments may contain additional conditions and obligations not specified by the Regulation, which should not be taken into account when determining the type of derivative financial instrument.

Advantages

The Regulation establishes a detailed description of derivative instruments, which should allow unambiguous interpretation of particular derivative financial instruments among all market participants.

Problems

The Regulation does not provide clear answers on a number of issues that have occurred as a result of its incorporation. In particular, it is not clear:

- a. whether the list of derivatives recognized by the FSFM is exhaustive; and
- b. whether the derivative financial instruments used in practice and having the same name as in the Regulation, but not falling within the description specified by FSFM, will be recognized by FSFM as derivatives.

Before the Regulation was enacted, the legislation already contained somewhat inconsistent descriptions of derivative instruments (types of "gambling" transactions enjoying judicial protection under Article 1062 of the Russian Civil Code; and the definition of the "derivative financial instrument" in the Securities

¹ The Regulation No. 10-13/пз-н dated March 4, 2010. The Regulation comes into force 10 days after its official publication.

² No. 39-ФЗ dated April 22, 1996 (as amended).

³ Article 2 of the Securities Markets Law.

Markets Law). The Regulation seems to create even more uncertainty in determining under Russian law how to qualify transactions traded in the market. Apparently, it does not cover all types of derivatives used in the market and further limits the definition because the descriptions of the derivatives contained in the Regulation narrow the above-mentioned descriptions (i.e., those previously provided in the legislation). The Regulation does not appear to cover, for example, swaptions or credit default swaps. In relation to the CDSs, although circumstances evidencing default are listed as the underlying assets, in practice it might be difficult to draft a CDS containing characteristics of the vanilla swap agreement described in the Regulation.

Likewise, the Regulation does not provide any guidance as to how derivative instruments under already existing contracts or derivative instruments which do not have all characteristics mentioned in the description should qualify. For example, the Regulation states that certain types of contracts should expressly state that the agreement represents a derivative financial

instrument. As a result, it is not clear whether an OTC forward contract would be recognized as such in the absence of an explicit provision saying that the contract is a derivative financial instrument. Such failure to determine whether the product is a derivative transaction may cause legal uncertainty in its regulation.

Further, since the list of the underlying assets mentioned in the Securities Markets Law and in the Regulation is not consistent with the description contained in Article 1062, judicial protection of derivative products under Russian law may be questioned.

Another problem, although, admittedly, this should be resolved by the Federal Law and not by the acts of the FSFM, is that while the definitions of derivative financial instruments identify each type of derivative as an agreement, the descriptions do not facilitate qualification of these agreements under Russian contract law. Consequently, determining which rules apply to a particular agreement may be problematic. This may cause a number of issues under Russian law, such as re-characterization risks, possible accountancy or taxation impediments, etc.

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