

# CIS LEGAL NEWSWIRE

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## RUSSIA

### Draft Law on Mortgage Investment Securities Passes its Third Reading

#### Summary

On October 14, 2003, the RF State Duma approved the draft Law "On Mortgage Investment Securities" (the "Draft Law") in its third reading. The Draft Law aims to establish a framework for the issuance of mortgage-backed securities through securitization. Such a framework could attract funds from the financial markets to the real estate sector which is in need of private funding.

The Draft Law seeks to protect holders of mortgage-backed securities issued by Russian special purpose vehicles ("SPV") or by Russian banks. Although certain provisions of the Draft Law give cause for moderate optimism (e.g., detailed requirements with respect to the composition of a mortgage pool), a number of issues (such as the broad discretion granted to the Central Bank of Russia ("CBR") to regulate mortgage lending activities of Russian banks and unclear bankruptcy rules among others) are less encouraging.

#### Background

President Putin recently encouraged mortgage lending referring to it as an important tool for providing residential housing and an important area of state policy. Most of the recently launched mortgage lending programs in Russia were established with the substantial involvement, and support from, the federal government and organizations supported by the government. For example, DeltaCredit Bank, a leading mortgage lender, is owned by the US-Russia Investment Fund (an investment vehicle sponsored by the U.S. Government), and receives substantial financing from multilateral development banks. In general, private funding of Russian mortgages is limited.

The existing legal framework for mortgage lending in Russia is based on two principal laws: the Law on Mortgage, dated July 16, 1998 (as amended) (the "Mortgage Law") and the Law on Registration of Rights to Immovable Property and Transactions Therewith, dated July 21, 1997 (as amended) (the "Registration Law"). The Registration Law has recently been amended to further improve the registration system. Please see the article entitled "Registration of Real Property Becomes a More Reliable System" in this issue of 'Newswire' for a more detailed description. The adoption of these two laws decreased, to a certain extent, title risks in real estate transactions and has allowed lenders to begin mortgage financings, which were previously not possible due to the unclear legal framework. Specifically, there was no reliable registration system. The new laws (including recent amend-

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ments to the Registration Law) substantially improved the situation.

The Draft Law seeks to put in place a legal regime for securitization of mortgages. Securitization would allow banks to "repackage" mortgage receivables as marketable securities and sell them to investors, attracting funds from the financial sector and strengthening the growing operations of Russian banks in this sector.

Forming a pool of mortgages and pledging that pool as collateral for attracting financing is possible under the existing legal framework. Specifically, this may be done through the use of mortgage certificates (*zakladnaya*), an instrument contemplated by the Mortgage Law. The mortgage certificate, which evidences the loan obligation of the borrower to the lender, as well as the encumbrance on the borrower's real estate, may be transferred or pledged. Therefore, existing legislation already provides for an instrument - the mortgage certificate, which, in principle, may be used in mortgage securitization transactions.

### Types of Mortgage Securities. Mortgage Coverage

The Draft Law provides for two types of mortgage securities: (i) mortgage-backed bonds, defined as bonds secured by a pledge of "mortgage coverage" (i.e., essentially a pool of individual mortgages); and (ii) mortgage participation certificates, securities confirming a share in the common ownership of mortgage coverage.

Mortgage coverage may be comprised of the following: (i) receivables under individual mortgage loans (which may be evidenced by mortgage certificates); (ii) mortgage participation certificates confirming the holder's share in the common ownership of mortgage coverage; (iii) state securities; and (iv) immovable property.

The Draft Law establishes fairly detailed requirements with respect to mortgage coverage aimed at controlling the quality of the mortgage pool. For example, mortgage receivables secured by real property under construction may not exceed ten percent of the mortgage pool. The Draft Law also lists specific documents which should evidence claims included in the mortgage pool.

The issuer is required to maintain a mortgage coverage register, which should contain information on the individual mortgages forming the mortgage pool.

### Issuers

An important issue debated early on in connection with the Draft Law was whether the securitization business would essentially be carried out by the banking sector, which is regulated by the CBR or whether the securitization business would be principally in the hands of specialized mortgage entities under the supervision of the FCSM.

The Draft Law provides that both SPVs and banks may issue *mortgage-backed bonds*.

*Mortgage participation certificates* (the second type of mortgage-backed securities provided by the Draft Law), on the other hand, would be issued by commercial organizations with licenses for administering investment funds, unit investment funds and private pension funds.

### SPVs

An adequate SPV regime is a key element in making securitization via international capital markets possible. An SPV should, in theory, offer the benefit of isolating a mortgage pool on the SPV's balance sheet, and thus, limit the credit risk to a specific mortgage pool.

The Draft Law seeks to establish this approach by putting forward a number of requirements and control mechanisms with respect to an SPV (such entity is called a specialized "mortgage agent" in the Draft Law). Specifically, the Draft Law formally limits an SPV's capacity to conduct non-mortgage activity. "Mortgage agents" are authorized to conduct activity only with respect to the "acquisition of claims under loan agreements secured by a mortgage, and (or) mortgage certificates." Mortgage agents would not be allowed to have staff. The functions of an executive body of the mortgage agent would be carried out by a commercial organization not affiliated with the company's shareholders. The bookkeeping of a mortgage agent would be maintained by an outside organization. Additionally, mortgage agents would not be allowed to enter into any agreements with individuals or to conduct only commercial activity other than as provided for by the Draft Law.

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Notably, the Draft Law allows an SPV to only be established in the form of a joint stock company (not an LLC), meaning SPVs would be subject to the regulations of the FCSM.

These measures are a commendable attempt to create a viable Russian SPV regime. However, a more elaborate framework for SPVs may be required. Serious legal questions may arise in connection with the transfer of receivables from a mortgage bank to an SPV and the enforceability of such transfers in light of existing court practice. An additional practical obstacle is that the procedure for transferring the security package from a mortgage bank to an SPV may be cumbersome and time-consuming, and thus, it may substantially slow down the process of issuance of securities.

The use of a non-Russian SPV may need to be considered as an alternative, although there are a number of currency regulatory issues and other implications which must be addressed.

### Banks

Another option is the direct issuance of mortgage-backed securities by Russian banks (as opposed to using an SPV in the process). However, direct issuance of mortgage-backed securities would not have the key feature of bankruptcy-remoteness of the issuer, a principal expectation underlying securitization through the international capital markets. Such securities would probably be viewed by international markets with caution.

It is therefore likely that achieving a satisfactory credit rating for mortgage-backed securities issued by Russian-owned banks would be problematic. In this case, a guarantee from state entities or other credit enhancement (including extensive over-collateralization) would likely be necessary.

### Conclusion

The Draft Law is a commendable attempt to open the Russian mortgage system to financial markets, by establishing, at least in principle, an SPV approach to the issuance of mortgage-backed bonds. It should be noted that the use of an SPV is the traditional approach in international mortgage securitization and a focus on creating a reliable SPV regime (as opposed to the option of Russian-owned banks issuing mortgage-backed securities directly) has greater potential in Russia.

It remains to be seen whether the existing provisions of the

Draft Law would be sufficient to make mortgage-backed securities an attractive investment instrument with an adequate credit rating. However, it is likely that broader legislative efforts, especially clarification of bankruptcy issues, will be necessary. */I. Glotin / L. Brank*

## Supreme Arbitration Court Addresses Rights of Shareholders and Pledge-holders

The arrest of shares by Russian courts as an interim judicial remedy has raised many questions and concerns, one of the most significant being whether upon seizure, the shareholder retains the authority to exercise the rights and enjoy the benefits of share ownership. Recently the RF Supreme Arbitration Court directly addressed the issue of whether the seizure of shares pursuant to a court order would prevent the owner of such shares from voting at general shareholders' meetings or from exercising other rights attributable to such shares in Informational Letter No. 72, dated July 24, 2003 (the "Informational Letter"). The RF Supreme Arbitration Court concluded that the seizure of shares should not automatically mean that a shareholder may not exercise any of its shareholders rights. Rather, as described below, the RF Supreme Arbitration Court indicated that several factors should be considered in determining whether a shareholder retains the authority to exercise its rights.

The Informational Letter states that if an applicant is seeking a protective measure expressly prohibiting a shareholder from voting at a general shareholders' meeting, the applicant must prove that: (a) the court's failure to grant this measure will hinder or render impossible the implementation of a court decision; and (b) the measure is necessary and sufficient to prevent significant damage from being caused.

More specifically, the RF Supreme Arbitration Court states that upon the seizure of any shares by a court, their further disposal is prohibited. The disposal of shares is to be broadly interpreted to mean any type of transaction involving the seized shares, including a transfer to a nominal holder not-

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withstanding the fact that such transfer does not result in a change in the ownership of the shares.

The RF Supreme Arbitration Court also addressed whether upon the seizure of securities, the owner would nevertheless have a right to receive dividends on such securities. The RF Supreme Arbitration Court noted that a court bailiff should not ban the receipt of income accrued on securities seized on the basis of a court decision if such court decision does not explicitly prohibit the holder of the securities from receiving income accrued on the securities in question.

The RF Supreme Arbitration Court also issued an important clarification with respect to the rights of a pledgee of securities. According to the Informational Letter, an arbitration court should not authorize the seizure of securities in favor of a creditor seeking to recover money in a dispute unrelated to the securities if such securities are pledged in favor of another creditor. The Informational Letter describes a case in which a lower arbitration court decided in favor of a claimant seeking the arrest of securities owned by the defendant. In that case, the lower arbitration court ordered the arrest of the securities which were pledged in favor of another creditor. The pledgee challenged the lower court decision to arrest the securities in which it had a security interest. Under the RF Civil Code, the pledgee was entitled to be paid from the proceeds arising out of the value of the pledged securities ahead of other creditors of the defendant, including in particular, the original claimant. Thus, as the original claimant did not have priority over the pledge, the claimant could not be satisfied out of the proceeds arising from the sale of the pledged securities. It appears, therefore, that the seizure of the securities would not secure the implementation of the court decision in the described case. To the contrary, the seizure would infringe upon the rights of the pledgee by depriving it of the possibility to foreclose upon the securities before the arrest of the securities had been lifted. On this basis, the appellate court ruled in favor of the pledgee, and the RF Supreme Arbitration Court appears to support this interpretation of a pledgee's rights.

The Informational Letter also provides certain recommendations with respect to the grounds on which a court may validly grant protective measures in claims involving securities. For example, the Informational Letter states that if the securities that are the subject of a seizure request are also the subject of a related court dispute, the possibility that the defen-

dant may transfer the securities to a third party is a sufficient basis for an arbitration court to seize such securities. However, based upon the legal norm that protective measures must be proportionate to the amount of the claim, a court ruling to seize securities held by a defendant, as well as the writ of execution issued on the basis of such court ruling, must specify the type and amount of the securities at issues. / *E.Abrossimova*

## FCSM Unifies Rules of Play on the Securities Market

On September 22, 2003, the new "Standards on the Issuance of Securities and Registration of Securities Prospectus," approved pursuant to Decree No. 03-30/ps of the Federal Commission for the Securities Market of Russia (the "FCSM"), dated June 18, 2003 (the "New Issuance Standards"), came into force. The New Issuance Standards replace three different sets of standards previously adopted by the FCSM in separate decrees. The FCSM additionally abolished three other outdated standards.

The adoption of the New Issuance Standards represents an attempt to unify and codify previous fragmentary regulations governing the procedures for the issuance of shares, bonds and options. The New Issuance Standards cover issuances of shares as part of the establishment of a company and in connection with any subsequent charter capital increases.

The New Issuance Standards specify the procedures for the issuance of:

- shares upon the establishment of the issuer;
- additional shares to be distributed among shareholders;
- shares in cases where the nominal value of the shares is increased or decreased, rights attributable to the shares are modified, or where shares are consolidated or split;
- securities (i.e., shares, bonds and options) distributed through subscriptions;
- securities distributed upon conversion of convertible securities; and

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- securities in connection with various types of corporate reorganizations of the issuer (i.e., transformation, merger, acquisition, division and spin-off).

Previously, these categories of issuances were covered by several different regulations.

Furthermore, the New Issuance Standards introduce a number of new regulations pursuant to amendments to the Federal Law "On the Securities Market," which became effective on January 4, 2003 (for a detailed review of this new law, see the March 20, 2003 issue of the *CIS Legal Newswire*).

### Independent Financial Consultants

The New Issuance Standards contain a number of requirements applicable to independent financial consultants who sign prospectuses for securities to be issued in a public offering. For example, if the registration of a securities issuance is accompanied by the registration of a prospectus, then a financial consultant is obligated to monitor whether the issuer complies with applicable law and the decision on the securities issuance. For such purposes, a financial consultant is, *inter alia*, authorized to approve the register of applications to purchase securities. If any violations occur with respect to the placement of securities, and such violation could result in a material infringement of investors' rights, then a financial consultant is obligated to report such fact to the FCSM within one day after the discovery of the violation.

### Issuances of Bonds and Options

The New Issuance Standards contain detailed regulations on the issuance of bonds secured by different types of collateral, i.e. pledges, sureties, bank guarantees, and state or municipal guarantees.

The New Issuance Standards also introduce a new category of bonds - "increased risk investment" bonds. The acquisition of bonds is recognized as an increased risk investment if the amount of all obligations under the bonds, including interest, exceeds the amount of: (i) the issuer's net assets; (ii) the collateral securing the bonds; or (iii) the net assets of the guarantor if the amount of the surety or bank guarantee issued by such guarantor exceeds the amount of such guarantor's net assets. In any of these cases, the securities prospectus must indicate that the acquisition of such bonds is undertaken by the purchaser at an increased level of risk.

In addition, the New Issuance Standards contain various requirements with respect to the issuance of options. For instance, if the holder of an option fails to demand conversion of the option into additional shares within the prescribed period of time, then all rights with respect to such option are deemed terminated, the option is canceled and the holder of such option is not entitled to any compensation.

### Registration Issues

The New Issuance Standards expand the grounds pursuant to which the FCSM may refuse to register an issuance of securities. For example, the FCSM may refuse to register an issuance if:

- the issuer fails to submit documents to the FCSM within 30 days after they have been requested; or
- the issuer's financial consultant fails to satisfy any applicable requirements.

In addition, the failure of the issuer to submit documents for registration within the prescribed time period may be grounds for the FCSM to refuse to register a securities issuance report.

Previous regulations specifically prohibited the FCSM from refusing to register a securities issuance report solely due to the issuer's failure to timely submit all registration documents.

The New Issuance Standards also provide that when registering secured bonds, the issuer must submit a report from an appraiser and a document evidencing the pledgor's ownership of the pledged property (if the bonds are secured by a pledge), and a copy of the guarantor's accounting reports (if the bonds are secured by any other type of security).

### Securities Placement

The New Issuance Standards provide that the terms and conditions for distributing securities through subscription may not exclude or substantially hinder the ability of willing buyers to purchase such securities, *inter alia*, by granting preemptive rights exclusively to certain purchasers.

In addition, the New Issuance Standards clarify certain as-

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pects of issuing shares during the establishment of the issuer. For example, when establishing a joint stock company, the initial distribution of shares to the founders should occur on the date of such company's State registration. Under an exception to the securities registration requirements, this distribution may take place prior to the State registration of the share issuance.

### Information Disclosure

The New Issuance Standards establish new requirements with respect to disclosure of information by issuers of securities. Under the new regulations, when the registration of a securities issuance is accompanied by the registration of a prospectus, it is necessary to submit documents to the FCSM evidencing that the issuer has disclosed all information as required by law, i.e. the issuer has published all necessary reports with respect to the adoption and approval of the issuance decision. Examples of such evidence include a copy of a publication circulated in the mass media, or a printout from the issuer's website or the website of a financial consultant.

The New Issuance Standards represent a significant attempt to streamline the standards applicable to securities offerings and to create greater stability in the market. Furthermore, since the New Issuance Standards were prepared based upon recommendations made by the International Organization of Securities Commissions, certain experts believe that the regulation of the Russian securities market is at last approaching international standards. /D.Gubarev, A.Kelina

## Registration of Real Property Becomes a More Reliable System

The RF State Duma recently adopted extensive amendments to RF Law No. 122-FZ "On Registration of Rights to Real Property and Transactions Therewith," dated July 21, 1997 (the "Registration Law"). The adopted amendments, in practice, create a new version of the Registration Law (the "Amended Registration Law"). The Amended Registration Law became effective on September 17, 2003, and is intended to increase the reliability of the system of registering Real Property in Russia.

### Clarification of Procedures of Re-registering Existing Rights to Real Property

The Amended Registration Law clarifies the procedures for state registration of title to real property existing prior to January 31, 1998 (i.e., prior to the creation of the Uniform State Register of Rights to Real Property and Transactions Therewith pursuant to the Registration Law (hereinafter, the "Register")).

Previously, the Registration Law generally recognized titles to real property validly existing prior to 1998 which had not yet been registered with the Register ("existing title") and required that, in certain cases, the acquirer must register such title with the Register, although the list of such cases where such registration would be applicable was ambiguous.

The Amended Registration Law clarifies that the registration of existing rights to property with the Register is necessary in the following cases: (i) where the registration of the transfer of an existing title occurred after 1998; (ii) where the registration of a transaction with real property occurred after 1998; and (iii) where the registration of an encumbrance (restriction) on the existing title occurred after 1998.

In order to encourage the filing of applications for the registration of existing rights to property and thereby accumulate in the Register greater information about existing rights to real property, the Amended Registration Law provides that the state fees for the registration of existing rights are waived in the first two cases referenced above and half of the amount of state fees shall be paid in all other cases involving the registration of existing rights.

Moreover, the registration of existing rights to real property, as expressly provided in the Amended Registration Law, may be carried out simultaneously with the registration of a contemplated transaction involving such real property within one month from the date on which all documents necessary for the currently contemplated transaction are filed.

### Clarification of Registration Procedures

The Amended Registration Law updates the procedures for the state registration of rights to real property or transactions

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involving real property, including procedures for suspension, refusal and termination of state registration. The Amended Registration Law also details the process of filing documents for registration. Previously, the Registration Law provided that either party to an agreement involving real property could file for registration if the agreement was certified by a notary. The Amended Registration Law establishes that both parties to an agreement must file documents for state registration. However, with respect to filing documents to register a mortgage agreement (which requires notarization), the Amended Registration Law specifically provides that either party may file for registration.

Additionally, the Amended Registration Law now requires that a power of attorney authorizing an applicant's representative to file documents with a state real property registration authority (the "Registration Authority") be notarized.

### New Form of an Extract from the Register

Among the most important changes introduced by the Amended Registration Law is the requirement that an extract from the Register must now contain data with respect to pending claims (including judicially filed claims) involving real property as of the date when such extract is issued by the Registration Authority. This new requirement should provide greater protection to purchasers of real property. Now a *bona fide* purchaser may receive an extract from the Register prior to a transaction involving real property and in the future, if the need arises, use that extract as evidence of its lack of knowledge prior to the transaction of any existing claim involving such property. However, it is unclear what the legal effect on such pending claims would be if the claims are not officially filed with the Register and if the real property was sold to a *bona fide* purchaser, i.e., whether the lack of information regarding such claims automatically grants the *bona fide* purchaser protection against such claim or not. Taking into account these new provisions, it is advisable to immediately inform the Register of any claims (whether filed or only planned to be filed with a court) with respect to real property to ensure that the title to such real property does not pass to a *bona fide* purchaser without its express knowledge of such claims. The Amended Registration Law established that extracts requested from the Register must be issued within five business days of a request therefore.

### New Provisions on Registration of Transactions Involving an Enterprise

The Amended Registration Law also introduces new provisions regarding registration of the sale and mortgage of enterprises. The new provisions are presumably aimed at clarifying the registration of this type of transaction, which at present is not frequently used in Russia due to the vagueness of the legal framework. The Amended Registration Law clarifies that transactions shall be registered by the Registration Authority at the location of the party acquiring title, or if such party is a foreign legal entity, by the Registration Authority at the location of the Russian party participating in the transaction. The Amended Registration Law further provides that registration of a transaction involving an enterprise provides grounds for the registration of the respective title to all objects of real property constituting the enterprise. However, it remains unclear whether registration of the title to particular objects will be performed automatically by the Registration Authority or if the party acquiring title must submit an additional application.

### New Federal Authority

According to the new registration regulations issued by the State Construction Committee 'Gosstroy', the RF Construction Ministry, the technical registration of real property was transferred to the federal level.

In the past, municipal bodies (so-called "Bureau of Technical Inventarization" or "BTI") were responsible for the collection of technical information regarding real property. Now, the federal body FGUP "Rostechinventarizatsiya" and its local subdivisions will collect/keep technical information with respect to real property.

It is planned that Rostechinventarizatsiya will create a unified electronic register of technical information regarding real property by the beginning of 2004. This register is aimed at decreasing the number of unregistered immovable property, mainly summer houses, as owners of unregistered real property often fail to pay real property taxes. / J.Romanova, E.Abrossimova

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## Russian Pension Reform Gathers Momentum

Preparations are underway for the implementation of Russia's pension reform program scheduled to commence in 2004. The reform will eventually transform the Russian pension system from a "Pay-as-You-Go" scheme, in which today's workers pay today's pensions, to one where each worker manages his or her own retirement funds. The new legislation is expected to bring investment funds into the Russian financial markets and supplement the currently insufficient tax revenue available for pensions.

To take advantage of the reform, Russian workers must choose a state-sanctioned professional to manage their savings by the end of this year. To date, the Finance Ministry approved 55 such money managers via a bidding process. Failure to timely choose an entity from that list will keep Vneshekonombank, the state-owned manager, in control of one's pension. Notably, Vneshekonombank has significantly less investment options under the law than private companies.

Thanks to the Russian Cabinet extension on September 17th, the government has until November 1 to mail account information to all future pensioners, who then have until December 31, 2003 to make their manager selections. The RF Pension Fund must process these selections by March 1, 2004, and transfer the funds to chosen management companies by March 31, 2004. A subsidiary of a state-owned company, Vneshtorgbank, will serve as a temporary depository of the accounts to those who choose a private manager.

According to a Troika Dialog estimate, although the inflow of new funds into Russian capital markets will occur very gradually, by the end of the decade, private firms will already control 70% of the money in the country's pension accumulation system. The new law retains the same eligibility requirements for receiving a pension – all 60-year old males/55-year old females with at least 5 years of work experience.

Besides the infusion of funds into the capital markets and the elimination of the cash crunch of "Pay-as-You-Go," the reform has the additional benefit of a curb on corruption, according to Labor Minister, Alexander Pochinok. The monthly statements will allow Russians to ensure that their employers are indeed making prompt pension payments on their behalf.

In view of the above benefits, most commentators agree that Russia's pension reform initiative will bring social and economic improvements in the foreseeable future. /V. Daynovsky

## New Reduced Tax Rates on Dividends

The US Treasury published a list in late September of countries whose corporations will be favored under the new reduced tax rates on dividends.

The United States cut the tax rate that individuals holding shares in corporations have to pay on their dividends to 15% earlier this year. This applies to dividends received from US companies. It does not always apply to dividends received from foreign corporations.

One way dividends from foreign corporations qualify is if the foreign corporation has its tax residence in a country with a "comprehensive" tax treaty with the United States. The US Treasury published a list of such countries in late September. There are 52 countries on the list, including the United Kingdom, Holland, Luxembourg and many other countries in Europe and Asia but only one Latin American country (Venezuela). The Treasury singled out four countries that it said *do not* have suitable tax treaties. They are Bermuda, the Netherlands Antilles, Barbados and some former Soviet republics still covered by the US-USSR tax treaty. Russia, Ukraine and Kazakhstan are included among the 52 "good" countries. /K.Martin (Washington, D.C)

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