

December 30, 2009

Amendments to Russian Regulation of Derivatives and Repos

The amendments to Federal law No. 39-FZ, "On Securities Markets," dated April 22, 1996¹ ("**Securities Markets Law**"), introduce legislative regulation of derivative instruments and REPO transactions. The amendments come into force January 1, 2010, except for certain provisions. There are a number of significant improvements to the older law. For example, the amendments distinguish derivatives from other financial instruments and securities and mitigate enforcement risks of the commonly used provisions in the transactions, such as early termination provisions. However, the new legislation does not always take into consideration existing rules on derivatives, and it imposes substantial restrictions on derivative transactions with the foreign counterparties. Below is an overview of some most important amendments.

Derivative Financial Instruments

The amended Securities Markets Law defines a derivative financial instrument. In addition to traditionally recognized and commonly used instruments (forwards, swaps and options linked to commodities, securities, FX, interest rates and rates of inflation), it provides for legislative recognition of instruments that are less traditional for the Russian market, e.g. credit default swaps and weather derivatives. Arguably, the definition of the derivative financial

instrument excludes the deliverable transactions "today", "tomorrow" and "spot". It also appears to exclude deliverable forwards if the relevant agreements do not expressly state that such forwards constitute derivative financial instruments.

The law states that over-the-counter credit default swaps may only be made if the seller of credit protection is a credit institution, broker or dealer and the buyer is a legal entity.

The definition of a "derivative financial instrument" does not fully correspond with the description of derivatives as a kind of "gambling" transaction which enjoy judicial protection under Russian law (Article 1062 of the RF Civil Code). Accordingly, the derivative financial instruments recognized under the Securities Markets Law may not necessarily have judicial protection under Article 1062. Hence, the Civil Code will have to be amended to eliminate this inconsistency.

Transactions Through Brokers

From January 1, 2010, transactions involving derivative financial instruments designated for qualified investors² may only be made through a licensed Russian broker (except for transactions with investors qualified by law, including banks and international financial organizations, or in

¹ By Federal law No. 281-FZ, "On Amendments to Part One and Part Two of the Tax Code of the Russian Federation and Certain Legal Acts of the Russian Federation," dated November 25, 2009.

² A person (natural person or legal entity) designated as a qualified investor by the Securities Markets Law (including credit institutions and international financial organizations) or a person which obtains qualified investor status as determined in the Securities Markets Law.

situations specifically set out by the Federal Securities Markets Service).

The Federal Securities Markets Service should determine whether a transaction is a derivative financial instrument. However, the amendments affect transactions involving "foreign derivatives" because under the Securities Markets Law transactions involving "foreign financial instruments" may only be made with qualified investors. Following the amendments, the definition of "foreign financial instrument" would cover "foreign derivatives" (by analogy with the definition of "financial instrument", which will expressly include derivative financial instruments under new law). Accordingly, from January 1, 2010 derivative transactions with non-Russian counterparties may only be made through brokers unless they are entered into with investors qualified by operation of law.

REPO Transactions

The law defines a repo transaction as a transaction where one party (the seller in a repo transaction) undertakes within the term stipulated by the agreement to transfer the ownership title to the securities to the other party (buyer in a repo transaction), and the buyer undertakes to take such securities and pay a certain amount for them (the first part of the repo transaction). The buyer undertakes within the term specified by this agreement to transfer ownership title to the securities to the seller, and the seller shall take such securities and pay for them (the second part of the repo transaction).

This definition replaces the previous definition set out under the RF Tax Code and significantly mitigates the risk of the repo transaction being re-qualified as a pledge of shares (as happened in the past).

A repo transaction with an individual may be entered into only with a broker, dealer,

custodian, asset manager, clearing organisation or credit institution (or through the broker).

The following assets may be used in a repo transaction according to the new law:

- issuance (*эмиссионные*) securities of a Russian issuer;
- investment units (*инвестиционные паи*) of unit investment fund(s) (*ПИФы*) managed by a Russian asset manager;
- shares or bonds of a foreign issuer; and
- securities of a foreign issuer evidencing the rights in relation to securities of the Russian and/or foreign issuers.

Terms of REPO Transactions and Derivative Transactions

The law establishes that the terms and conditions of REPO transactions and derivative transactions may be specified by framework or master agreements, including agreements published in standard forms by self-regulated organisations (i.e. ISDA, ISMA, etc.). The confirmation of the derivative and repo transaction must specify which master agreement is applicable to the transaction.

Framework agreements for derivative transactions may specify the grounds for early termination under all transactions entered into pursuant to the master agreement (including unilateral termination upon the default of the counterparty), and calculation of the termination amounts. An early termination provision may also be included in a repo agreement. These amendments substantially mitigate the risks related to the enforceability of automatic early termination provisions under standard master agreements, as the law expressly provides that the parties may specify such provisions in their agreements. However, the new law is still silent on early termination in case of bankruptcy of the counterparty to the agreement.

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