

# Special Update on Clearing and Netting in Russia

24 March 2011



This Special Update discusses the recently enacted Federal Law No. 7-FZ "On Clearing and Clearing Activities," dated 7 February 2011 (the "**Clearing Law**") and Federal Law No 8-FZ "On Amending Certain Legal Acts of the Russian Federation Following the Enactment of the Federal Law 'On Clearing and Clearing Activities'," dated 7 February 2011 (the "**Amending Law**").

On 7 February 2011, following their approval by the Russian Parliament, the President of the Russian Federation signed into law the Clearing Law and the Amending Law. The Clearing Law establishes a unified legal framework for clearing activities in Russia and is expected to contribute significantly to the development of the Russian financial market. The Amending Law, among other things, introduces into Russian bankruptcy laws the possibility of close-out (liquidation) netting under derivative, repo and certain other transactions.

## The Clearing Law

### Background to the Introduction of the Clearing Law

Although certain fragmentary regulation of clearing existed in Russia, including references to clearing in the Russian Tax Code, the Law on the Central Bank of Russia and the Securities Market Law, it would be fair to say that before the introduction of the Clearing Law, clearing activities were never subject to specific comprehensive statutory regulation in Russia.

The Clearing Law has been prepared as a major follow-up on the "Strategy for the Development of the Russian Financial Markets until 2020" adopted by the Russian Government in December 2008. The main idea and goal of the Clearing Law is further development of a competitive risk management system for Russian market players.

### Principal Provisions of the Clearing Law

#### Key definitions

The Clearing Law defines "*clearing*" as "determination of due obligations arising out of agreements, including through the netting of such obligations, and preparation of documents (information) for the termination or performance of such obligations" and "*clearing activities*" as "the rendering of clearing services in accordance with clearing rules adopted by a clearing organization and registered in accordance with the established procedure with the federal state regulator in the securities market sphere."

The Clearing Law also introduces such terms as the "*clearing participant*" (being the recipient of clearing services from a clearing organization under a clearing services agreement), "*netting*" (full or partial termination of obligations admitted to clearing by way of a setoff or otherwise in accordance with the clearing rules) and "*central counterparty*" (a legal entity which complies with the respective requirements of the Clearing Law and is a party to all the agreements included in

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the clearing pool).

## *Clearing organizations*

In accordance with the Clearing Law, only a Russian commercial legal entity may perform the functions of a clearing organization and a central counterparty. The Clearing Law lists a number of requirements for qualification as a clearing organization. Such requirements include, among others: (i) the requirements to the minimum amount of such organization's own funds (set at RUB 100 million), (ii) the requirements to the founders, management bodies and employees of such organization, and (iii) certain other internal requirements (such as the need to set up an effective internal control system, etc.).

A clearing organization is prohibited from (i) carrying on production, insurance and trading activities, as well as activities connected with the trust management of joint stock investment funds, mutual funds and non-public pension funds, and (ii) being a registrar, a non-public pension fund, a joint stock investment fund, or a special depository of joint stock investment funds, mutual funds and non-public pension funds. The Clearing Law also lists a number of limitations related to practices of combining clearing activities with broker, dealer and securities management activities, as well as activities related to the organization of trading on the securities market.

Clearing activities are subject to licensing requirements in the Russian Federation. Registration of clearing organizations and issue / revocation of relevant licenses shall be effected by the Federal Service for Financial Markets of the Russian Federation (the "FSFM").

Clearing organizations are also required to make proper disclosure of their activities in accordance with the Clearing Law (in particular, a clearing organization is required to disclose its clearing rules, foundation documents and annual reports, including audit reports in relation to its financial statements).

## *Clearing security*

The Clearing Law provides for a number of risk management tools for ensuring effective operation of the clearing system. In particular, one of the innovations under the Clearing Law is the concept of "*clearing security*" used to secure the obligations of clearing participants. Clearing security may be individual (securing the respective obligations of specific clearing participants) and/or collective (securing the obligations of any clearing participant through the establishment by a clearing organization of a special security (guarantee) fund). Clearing security may include money (rubles or foreign currencies), securities and other property listed in respective statutory regulations, save for pledged property.

## **The Amending Law**

### **General Overview of the Amending Law**

In connection with the enactment of the Clearing Law, the Amending Law introduced respective amendments to a number of laws, including the Securities Market Law, the Law on Banks and Banking, the Bankruptcy Law, the Credit Organizations Bankruptcy Law and certain others.

One of the major Russian legislative innovations introduced by the Clearing Law and the Amending Law is the *concept of netting*.

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Russian law was generally not familiar with the concept of netting before the introduction of the abovementioned laws. As a result, Russian courts considered netting as a form of setoff (being the closest Russian law equivalent), which was definitely a problem in the context of insolvency of Russian entities, mainly given that Russian insolvency laws (i) generally prohibited setoff in the course of insolvency proceedings, and (ii) granted the liquidator rights to repudiate certain transactions with a performance date not yet due (i.e., transactions unprofitable for the insolvent party).

## Introduction of Netting in Russia

In accordance with the Amending Law, close-out netting arrangements will be recognized in relation to repo transactions, derivative instruments or other transactions dealing with securities or foreign currencies and entered into between *eligible counterparties* under *eligible documentation*.

The amended Bankruptcy Law provides that obligations of parties under multiple transactions governed by a single master agreement may be terminated and that a single cash payment obligation (except any potentially applicable fines / penalties and lost profits) may be payable pursuant to the master agreement by one party to the other. To be eligible for such netting, the respective transactions need to be entered into prior to (i) the commencement of administration, or (ii) the ruling of a commercial court to introduce any bankruptcy procedure, or (iii) the revocation of a banking license (if applicable). The Bankruptcy Law also effectively prohibits "cherry-picking" in the context of bankruptcy proceedings, i.e. the bankruptcy administrator now may refuse to perform only all of the eligible financial transactions rather than some of the financial transactions.

In accordance with the amendments to the Bankruptcy Law:

The list of *eligible counterparties* includes:

(i) Russian banks and professional securities market participants (brokers, dealers, custodians, etc.); (ii) the Central Bank of Russia; (iii) non-Russian banks and professional securities market participants incorporated in an OECD / FATF / MONEYVAL jurisdiction ("**eligible jurisdiction**") or in a country whose securities market regulator or similar body has entered into a cooperation agreement with the FSFM ("**eligible country**"); (iv) non-Russian central (national) banks from an eligible jurisdiction or an eligible country; (v) international financial institutions (IFC, EBRD, World Bank, etc.); (vi) other Russian entities; (vii) the Russian Federation, its regions and municipalities; (viii) holders of investment units of mutual funds; (ix) eligible jurisdictions / eligible countries, their regions and municipalities; and (x) other non-Russian entities incorporated in an eligible jurisdiction or an eligible country.

At least one of the parties to the respective derivative transaction should be an entity listed in (i)-(v) above.

*Eligible documentation* includes (i) cross-border (international) documentation, and (ii) Russian standard documentation.

Cross-border (international) documentation may be used if one of the counterparties is a foreign entity. It includes master agreements developed by international organizations included in the list to be approved by the FSFM (it is understood that such list might include, among others, the International Swap Dealers Association, Inc.). Russian standard documentation includes domestic master agreements which are to conform to certain "model provisions" developed by Russian self-regulating organizations ("**SROs**") (it is understood that such

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documentation might include, among others, that recently developed under the auspices of ARB and NAUFOR). Such "model provisions" and any amendments thereto are also be approved by the FSFM.

Furthermore, in case of OTC transactions, in order for the netting arrangements to be enforceable, the Amending Law also requires inclusion of each respective agreement in the register kept by a stock exchange or by an SRO, which, in turn, is required to report to the FSFM.

**The Clearing Law will enter into force on 1 January 2012.**

**The Amending Law entered into force on 11 February 2011 (save for a few provisions that will enter into force on different dates: in particular, the rules allowing close-out netting will enter into force on 11 August 2011).**

This update is a general summary of recent legislative developments and should not be treated as legal advice. Readers should seek the advice of legal counsel on any specific question. All translations of terminology in this update are unofficial.

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