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Standard Russian Derivatives Documentation

New standardized documentation for over-the-counter derivatives in Russia, combined with close-out netting legislation, could open up the market to more OTC volume.

Background

Participants in the Russian derivatives market have historically used derivatives for hedging. Accordingly, the range of the instruments traded in the local market has been—and largely remains—relatively narrow, with plain vanilla fx and interest rate instruments being the most popular. Although other instruments, *e.g.,* equity and fixed income derivatives and repos, are not unfamiliar to Russian market participants, they account for a small fraction of the market.

The underdevelopment of the Russian derivatives market has largely been driven by the legal risks associated with the lack of regulation and inexperience of the local courts in the matter. One of the major risks has been unfamiliarity with Russian law concerning the concept of close-out netting, which we discuss in more detail below. Another major concern was the risk of unenforceability of net-settled derivatives under Russian law. Russian courts—most notably in their 1998-1999 decisions with respect to non-deliverable fx forwards—used to consider derivatives with a net payout to be unenforceable on the basis of Article 1062 of the Civil Code of the Russian Federation (the "Civil Code"), arguing that such transactions constituted gaming.

In February 2007, Article 1062 was amended to provide for enforceability of derivative transactions linked to any of the assets listed in the amendment provided that at least one of the parties to such transactions is a Russian bank or a Russian licensed "professional securities market participant" (broker, dealer, securities manager, etc.). The amendment provides that *"claims…of the party (or parties) involved in transactions that depend on the fluctuation of the price of commodities, securities, exchange rate of the relevant currency, level of interest rates, level of inflation (or estimates calculated on the basis of combination of these measures) or on the occurrence/non-occurrence of another event provided for in the legislation…should be enforceable if at least one of the parties is a [bank] or a professional participant of the securities market."*

The adoption of this amendment, as well as certain other legislative initiatives aimed at establishing specific regulation of derivatives in Russia, gave an impulse to extensive market discussions on the need for standardized documentation that would substitute individual bespoke documents used by market participants. In summer 2007, the **Association of Russian Banks** (ARB), the **National Associations of the Securities Market Participants** (NAUFOR) and the **National Currency Association** (NVA), with the support of the **International Swaps and Derivatives Association**, Russian regulators and a number of Russian banks, initiated a working group that would prepare a set of standard derivatives documentations under Russian law based on ISDA documentation. The Standard Documentation for Derivative Transactions in the Financial Markets (the "Standard Documentation") was officially published on 24 June 2009 on the Web sites of the ARB, NVA and NAUFOR.

Architecture

The Standard Documentation largely replicates the structure of the ISDA Master Agreement and is based on the principle of a single agreement covering multiple trades and the concept of calculating net exposure upon termination and applying "liquidation netting" (a concept very similar to the Close-Out Netting under the 2002 ISDA Master Agreement).

The Standard Documentation consists of:

(i) Model Terms of the Agreement on Derivative Transactions in the Financial Markets (the "Model Terms");

(ii) Form of the Master Agreement on Derivative Transactions in the Financial Markets attached as Schedule 1 to the Model Terms (the "Local Master Agreement"); and

(iii) Model Terms of the Agreement on Payment of Variation Margin under the Master Agreement on Derivative Transactions in the Financial Markets (the "Margin Model Terms") and the Agreement on the Payment of Variation Margin (the "Margin Agreement") (together, the "Credit Support Documentation").

These core documents can be supplemented by product model terms discussed in more detail below.

Model Terms

The Model Terms set out the relationship between the parties (*e.g.*, representations and undertakings; early termination triggers; calculation of payments due upon termination, *etc.*).

The main difference between the Model Terms and the ISDA Master Agreement is that the Model Terms are not executed by the parties but are incorporated by reference into the Local Master Agreement. Similarly to the ISDA Master Agreement structure, particular transactions are entered into pursuant to separate confirmations.

One of the principal differences of the Model Terms from the ISDA Master Agreement is the limitation in the scope of the transactions that can be concluded under the Model Terms. As discussed above, the changes to Article 1062 of the Civil Code that granted judicial protection to certain derivatives limited the scope of underlying assets for such protected transactions to those expressly listed in the amendment. In order to benefit from this specific reference, Clause 2.2 of the Model Terms limits the scope of "Transactions" covered by the Model Terms to "*FX spots; FX options; FX swaps; transactions with respect to interest rates (including interest rate swaps (including basis swaps; cross currency interest rate swaps; interest rate forwards; interest rate caps, collars and floors); swaptions; equity forwards, bond forwards and index forwards; equity options, bond options and index options; commodity swaps; commodity options; swaps, forwards and options on inflation; other analogous transactions (including options on the above) and the transactions representing a combination of the above*".

Local Master Agreement

The Local Master Agreement incorporates the provisions of the Model Terms and gives parties the ability to insert any negotiated supplemental terms or amendments to the Model Terms. Most of the concepts are very similar to the concepts set out in the Schedule to the ISDA Master Agreement (parties may insert references to Specified Entities, apply Cross-Default and Credit Event Upon Merger provisions, add any relevant Additional Termination Events, *etc.*). The Local Master Agreement also gives parties the ability to activate arbitration provisions.

Credit Support Documentation

Credit support can be posted pursuant to the Margin Agreement that incorporates (and to the extent necessary, amends and supplements) the Margin Model Terms. Posting of collateral pursuant to the Credit Support Documentation is very similar to the mechanics under the English law Credit Support Annex but the documents only allow for cash collateral.

Product Model Terms

The range of transactions covered by the standard documentation is limited to those listed in Clause 2.2 of the Model Terms. Accordingly, the working group has prepared the following product-specific model terms:

(i) Model Terms for FX Spot, FX Forward, FX Swap and FX Option Transactions;
(ii) Model Terms for Interest Rate Derivative Transactions and Interest Rate Swaptions;
(iii) Model Terms for Derivative Transactions on Equities and Indices; and
(iv) Model Terms for Derivative Transactions on Bonds.

Each of the product model terms sets out specific provisions relevant in the context of a particular type of transactions and attaches forms of confirmations to be used to document such transactions.

Principal Russian Law Concerns

One of the principal Russian law concerns that hinders the development of the local market is its unfamiliarity with the concept of close-out, or liquidation, netting. Russian insolvency legislation expressly prohibits set-off (which is the closest Russian law equivalent to "liquidation netting") in the context of insolvency.

Certain draft amendments to the Russian insolvency law are currently being considered by the Russian Duma (the lower chamber of the Russian Parliament) and have already been adopted in the first reading. These amendments are designed to allow liquidation netting in the context of insolvency provided that:

(i) the transactions terminated on the basis of the liquidation netting provisions have been entered into under a single master agreement between the parties (*e.g.*, the standard documentation);
(ii) all, and not less than all, transactions under the relevant agreement shall be terminated simultaneously; and
(iii) at least one of the parties to the relevant agreement is a Russian bank or a "professional securities market participant" licensed in Russia.

The draft amendments will need to undergo two more readings in the Russian Duma, will need to be approved by the upper chamber of the Parliament and signed by the President. At each of these stages, the wording of the proposed amendments can change. It is therefore impossible to predict at this stage whether and in what form will the "liquidation netting" concept be recognised. However, if the amendments are adopted substantially in the form of the current draft, the use of the standard documentation will be limited to transactions between, or with, Russian banks and Russian licensed "professional securities market participants".

Furthermore, the adoption of the amendment to Article 1062 did not fully resolve the enforceability issues surrounding derivatives in Russia. The amendment grants judicial protection only to transactions referenced to the assets listed in the amendment and provided that one of the parties to such transaction is a Russian bank or a Russian licensed "professional securities market participant". Accordingly, although the standard documentation is designed for use by any market participants, in order to benefit from the safe harbour of Article 1062, the net-settled transactions thereunder would need to be with, or between, Russian banks or Russian licensed "professional securities market participants".

Conclusion

The adoption of the standard documentation is a significant step forward that demonstrates the interest of the market participants, legislators and regulators in establishing a legal and documentation platform for further development of the local derivatives market. However, at this stage the proper functioning of the market in general and the standard documentation in particular is still subject to further legislative changes, the introduction of "liquidation netting" concept being one of such key changes. It is also unclear at this stage whether market participants would be willing to adopt the standard documentation or whether they would prefer to continue using their individually developed documents that are in many instances also based on the ISDA standard.

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