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The Russian OTC derivatives market – key developments

by Vladimir Khrenov, MZS & Partners

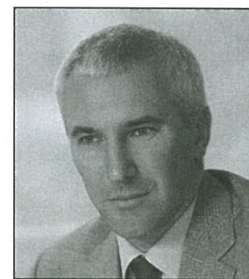
THE YEAR IN REVIEW HAS MARKED A NUMBER OF LONG-AWAITED MILESTONES IN THE DEVELOPMENT OF THE RUSSIAN OTC DERIVATIVES MARKET. THE PRINCIPAL CHANGES INCLUDE REGULATORY MEASURES DESIGNED TO IMPLEMENT THE RECENTLY ENACTED NETTING LEGISLATION AND TO COMPLY WITH THE G-20 MARKET INFRASTRUCTURE REFORM COMMITMENTS AS WELL AS MARKET INITIATIVES TO FURTHER BROADEN THE RANGE OF PRODUCTS TRADED IN THE DOMESTIC ON-EXCHANGE AND OTC DERIVATIVES MARKETS.

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Close-out netting

Reflecting a long-standing pro-debtor tilt of the Russian insolvency legislation, the contours of the netting regime were intended to be fairly confined. Federal Law No. 127-FZ 'On Insolvency (Bankruptcy)' (the 'Insolvency Act') provides that "[...] obligations arising out of contracts governed by a master agreement (single agreement) which corresponds to the model terms¹ envisaged by [the Securities Market Act] (hereinafter – financial contracts) shall terminate in accordance with the procedure set forth in said master agreement (single agreement) [...] Such termination shall give rise to a monetary obligation the amount of which is to be determined in accordance with the procedure set forth in the master agreement." The law thus appears to give deference to the close-out procedure set forth in the applicable master agreement. Such latitude, however, is checked by the requirement that the master agreement, if used for local market transactions, be based on a template developed by a Russian self-regulatory organisation and pre-approved by the Federal Financial Market Service (the 'FFMS'). In the context of cross-border transactions, a template master agreement is

eligible for netting only if developed by an international industry association pre-approved by the FFMS (currently, ISDA and ICMA). Further, the master agreement must meet certain parameters imposed by the Insolvency Act. The Russian templates of FFMS-approved master agreements² were updated following the enactment of the netting legislation and their netting-compliant versions were published in 2011. Parties using the ISDA Master



Vladimir Khrenov, Partner
MZS & Partners
tel: +7 495 231 4222
email: khrenov@mzs.ru

Agreement or the GMRA to document cross-border transactions also need to consider incorporating certain amendments to such agreements to ensure their netting eligibility for Russian law purposes. Finally, netting-eligible transactions must also meet a number of other criteria set out in the Securities Market Act and the Insolvency Act.

Both ISDA and ICMA have commissioned netting opinions in relation to the ISDA Master Agreement and the GMRA respectively. Such legal opinions will be made subject to a number of important assumptions and reservations.

Auxiliary regulations

Other regulatory developments affecting the derivatives market during the review period pertain to taxation and fair value accounting of OTC derivative transactions as well as prudential supervision of the banks' derivatives exposure. The FFMS has issued a regulation detailing the means of determining the current market value of outstanding derivative transactions, which is to be applied in assessing the parties' tax liabilities. The Russian Central Bank has also addressed similar issues, albeit from a slightly different angle, in prescribing new prudential standards applicable to the derivatives book of regulated credit organisations.

Trade data reporting

The principal hold-up in the implementation of the netting regime has been, and remains as of the time of writing, the absence of a full-range swap data repository. Immediate recordation of transaction details by an independent third party was the *sine qua non* of a legislative compromise reached in the run-up to the enactment of the netting reform legislation. Such recordation, in addition to being prompted by Russia's G-20 commitments, was viewed as a necessary safeguard against abuse of the netting regime by unscrupulous players acting in cahoots with the insolvent party in cancelling out liabilities to the estate through retrospectively creating in-the-money derivative positions. As a result, the Russian reporting regime has one important feature that sets it apart from similar

regulations in other jurisdictions. In the event of the insolvency of a party to a reportable transaction trade data registered by a trade repository prevails over conflicting provisions of the trade confirmation or other contractual documentation. While ostensibly a logical corollary of the above-mentioned compromise, this feature of the reporting regulation ups the ante for operational risk management and, unless the application of this rule is subject to some sort of judicial check, the potential cost of an operational error may be difficult to assess.

Provision of repository services has not yet been made a regulated activity and the relations between the repository and its clients are based on general contract law principles. Yet, even in the absence of formal licensing or supervision requirements, setting up a trade data repository in Russia represents a significant challenge. Most importantly, Russian market participants have been late in adopting the FpML – a technical language that in other markets has become an essential communication medium in swap reporting. The adaptation of FpML to Russian regulation and practices as well as its rollout among the market participants – a process that only started earlier in 2013 – need to be compressed into months while similar processes – albeit on a bigger scale – took years in the leading financial jurisdictions after the launch of the project in 1999. Secondly, the scope of transactions captured by the reporting obligation is not clearly defined. In addition to repos and traditional derivative transactions such obligation applies to “other types of transactions governed by a master agreement the object of which is securities or foreign exchange” which leaves the scope of such obligation potentially open-ended. Meanwhile, rather than allowing the repository to elect which types of transactions it will accept for recordation, the regulation endorses the ‘all-or-nothing’ approach by requiring any entity that wishes to offer repository services to register the entire spectrum of reportable transactions.³ Until the regulator defines clear criteria of reportable transactions a full-range repository service is unlikely to become available in the market. Also, depending on such criteria, the FpML may need to be further adapted for use by Russian OTC derivatives market participants.

OTC derivatives clearing

The implementation of mandatory clearing for OTC derivatives is less of a priority for Russia in comparison to other markets. The trading volume in the local interbank market for FX and rates instruments is primarily concentrated in short-dated swaps. Markets in other underlyings are still nascent (e.g. equity or commodity derivatives) or non-existent (credit derivatives) so the systemic risk concerns are less acute for the Russian regulators. The longer-dated trading flows in the end-user segment are steadily growing in volume but are not yet subject to mandatory clearing. Even without a statutory requirement for OTC clearing, however, the Moscow Exchange has announced plans to launch an interdealer CCP clearing platform for interest rate swaps, FX swaps and cross-currency swaps later this year. In addition to the benefits generally pursued by regulators in other G-20 countries, CCP clearing will provide the users of such service in Russia with more favourable risk weightings for regulatory capital purposes as well as an important protection from the insolvency claw-back risk affecting payments and margin transfers under uncleared OTC transactions. Client clearing will not immediately be available, but is likely to be implemented as part of the next phase of the project.

Standard documentation – phase two

The publication in 2009 by NAUFOR, ARB and NFEA* of an industry-standard template master agreement (model terms of a contract) (as amended in 2011 to meet new statutory netting eligibility criteria) and a first set of product definitions covering interest rates, foreign exchange, equities and fixed income securities has proved to be a major development in the evolution of the local derivatives market. Not only is it proving to be instrumental in achieving objectives generally associated with the harmonisation of contractual documentation, it has also received a de-facto monopoly status as a netting-eligible master agreement for use in the domestic derivatives market. No other form of master agreement has to-date been approved by the FFMS for netting purposes.⁵

This creates a strong economic incentive for market participants that do not use the standard documentation already to switch to such documentation in order to achieve the netting benefits denied to bespoke forms of master agreements.

Since 2009, however, the market has outgrown the range of asset classes included in the first set of definitions and phase two of the documentation project was announced by NAUFOR, ARB and NFEA to include (i) commodity derivatives; (ii) an addendum to the equity derivatives and fixed income securities definitions expanding their respective scope to capture foreign equity and fixed income securities; and (iii) credit derivatives. Commodity derivatives definitions have been published earlier this year, and the addendum to the definitions covering foreign equities and fixed income securities is currently a work-in-progress. Definitions for credit derivatives are scheduled for completion before year-end but will require certain regulatory changes to precede their publication. Ideally, the local documentation should follow the ISDA Credit Derivatives Definitions to enable closer interaction between the domestic and international markets. Currently, however, the use in the domestic market of a product similar to an ISDA-governed credit default swap would give rise to significant enforceability risks as well as uncertainty as to its tax and accounting treatment. Regulation needs to be enacted which defines all credit event triggers as an eligible underlying for financial derivatives. While such regulation is already in the works, it remains to be seen if the impending merger of the FFMS into the Central Bank will affect the timing of its enactment.

Court practice: bucking the trend

The efforts to improve the environment for the development of the derivatives markets in Russia have recently encountered a setback when Russian courts made their rulings in two similar disputes involving the Russian subsidiary of UniCredit Bank. The bank entered into fixed-for-floating interest rate swaps with two clients. The swaps were made under a bespoke Russian law-governed

master agreement developed by the bank for use with corporate clients. The master agreement provided *inter alia* that each party has the right early to terminate the agreement early provided that at the time of such termination there are no unperformed obligations between the parties. No payment of the mark-to-market amount was required in the event of such termination. The swap went out-of-the-money for the two clients each of which invoked the above termination provision and walked away from the swap. In doing so, the clients argued that because of the payment netting provision in the swap confirmation the parties have no unperformed obligations until the floating rate applicable to the relevant interest period has been fixed, a net payment amount has been determined and the payment date has occurred. The courts agreed with the above argument thus ignoring the fact that the parties' obligations under a

swap arise from the trade date and remain binding through the swap maturity date. The courts also failed to appreciate that the interpretation they have upheld defies the very foundation of the derivatives market and deprives the contract of any current market value that is based on the present value of future payment obligations. While the crux of both disputes is the issue of contract interpretation (and from that narrow standpoint the significance of these decisions should not be extrapolated to swaps generally), the inability of the courts to give the intended meaning to a seemingly innocuous contractual provision raises more general concerns about whether the Russian court system is well equipped to handle disputes arising out of these new types of financial transactions. The hopes are high, however, that the upcoming Plenary Meeting of the Supreme Arbitration Court will provide lower courts with necessary guidance.

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3/1 Novinsky Boulevard
Moscow 121099, Russia
t: +7 (495) 231 4222
f: +7 (495) 231 4223
e: moscow@mzs.ru
www.mzs.ru

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MZS' derivatives and structured products practice is one of the leading in the Russian market. The firm has recently been selected to draft the next generation of product annexes for use with the Russian industry-standard master agreement including commodity derivatives definitions, an annex to the equity and fixed income derivatives definitions expanding their asset class coverage to include foreign equities and fixed income securities, and the credit derivatives definitions. MZS has recently advised the National Settlement Depository on the pilot project to set up the first Russian swap data repository and is currently advising the St.Petersburg Exchange on setting up a second swap data repository as well as on the use of FpML. MZS currently acts as advisor to the Moscow Exchange on the pilot OTC derivatives clearing project. The firm represents and advises many of the largest sell-side and buy-side institutions – both Russian and international – as well as some of the largest Russian end-users on all aspects of innovative derivative and hybrid transactions and structured products in the domestic and cross-border markets.

Vladimir Khrenov is head of the MZS's derivatives and structured products practice. He was the lead drafter of the Russian industry-standard master agreement for derivatives and a credit support annex thereto ("model terms of a contract") as well as the first set of definitions for such asset classes as interest rate, foreign exchange, equity and fixed income securities – all as published by the Russian National Association of Securities Market Participants (NAUFOR), the Association of Russian Banks and the National Foreign Exchange Association. He was also the lead drafter of the revisions included in the 2011 netting-compliant version of said standard documentation. Vladimir was recently involved in the judicial training program in association with the EBRD and P.R.I.M.E. Finance for the Russian Supreme Arbitration Court and lower courts on derivatives-related matters.

Conclusion

The evolution of market regulation and the development of sound and reliable court practice conducive to a sustainable growth of the derivatives market are no easy tasks. The ever-sliding effective date of the close-out netting regime, unfortunate court judgments, remaining issues with credit support and the claw-back risk all remain among the causes for concern of the market participants. The practical reality of the market, however, is such that the market participants' efforts to address these challenges do not appear to yield. Through interaction between the industry, the regulators and the judicial bodies, the contours of the market structure are gradually becoming discernible.

Notes:

- 1 'Model terms of a contract' is a term of art under Russian law that refers to a published pro forma agreement incorporated by reference into a contract. Model terms of a contract play a similar role to the pre-printed form of the ISDA Master Agreement or the GMRA.
- 2 A template master agreement for derivative transactions was developed jointly by the National Association of Stock Market Participants (NAUFOR), the Association of Russian Banks (ARB) and the National Foreign Exchange Association (NFEA) and was first published in 2009. The National Securities Market Association developed a template master agreement for repo transactions.

- 3 The regulation was recently amended to allow repositories to phase the provision of repository services by segregating accepted transactions into three pools – repos, FX swaps and a catch-all pool of all other reportable transactions – and separately offering repository services in respect of each pool. Once a repository files an application with the FFMS for the provision of repository services in respect of any transactions that fall within the catch-all pool, it must offer repository services in respect of all reportable transactions other than repos and FX swaps. The National Settlement Depository has already commenced registration of repos and FX swaps and is planning on launching the rest of the service before year-end. Similarly, the St. Petersburg Exchange has announced an upcoming launch of the repository service for repos and plans to commence the service for the rest of the products before year-end.
- 4 Supra note 1.
- 5 As noted in note 2, a separate set of model terms of a contract has been developed for repos and approved by the FFMS.

Contact us:

MZS & Partners

3/1 Novinsky Boulevard, Moscow 121099, Russia

tel: +7 495 231 4222

fax: +7 495 231 4223

email: moscow@mzs.ru

web: www.mzs.ru/en/