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24 July 2003

Viktor S Pleskachevsky, MP
Chairman of the Russian Federation State Duma Property Committee
Okhotny rjad 1
Moscow 103265
Russia

Dear Mr. Pleskachevsky,

Federal Law on Derivatives

As you know, the International Swaps and Derivatives Association, Inc. ("**ISDA**") is an international financial trade association whose membership comprises over 600 of the world's largest commercial, merchant and investment banks, corporations, government entities and other institutions. ISDA's members represent a broad cross section of the institutions that act as dealers and end-users of swaps and other privately negotiated derivative transactions in 46 jurisdictions worldwide.

ISDA's commitment to promoting the development of sound risk management practices, and the particular interest of its Central and Eastern Europe Committee in the legal framework for over-the-counter derivatives and close-out netting in Russia, were set out in more detail in a memorandum distributed in connection with ISDA's March participation in an Experts' Committee Meeting of the Russian State Duma.

You have recently invited ISDA to comment on the draft text of Russia's Federal Law on Derivatives, and we are delighted to do so. We appreciate that this draft proposal is at a preliminary stage and may be the subject of debate and amendment. We would also be happy to provide more comments on certain issues as the legislative process proceeds.

We provide the comments that follow on the English language text of the draft law that was furnished to us at the time of our March visit to the Duma. The text may have since changed, and there may also be points reflected in our comments that arise from our reading of the translation but that may not be relevant when considered in the context of the Russian language version of the draft. We apologise in advance for our reliance on the English translation and any confusion that may have resulted from it.

We would note at the outset that ISDA applauds the efforts by your Committee and the Duma in seeking to improve the legal and regulatory framework for derivatives transactions in the Russian Federation. However, ISDA views the proposal to adopt a comprehensive federal law on derivatives as ambitious and, unless there is adequate opportunity and time for comment from the international marketplace, as risky. The approach taken in other jurisdictions has generally been different - usually in recognition of the complexities of the marketplace and the technical difficulties with agreeing and providing the detail contemplated in the draft Federal Law on

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Derivatives. If, nevertheless, the Duma elects to take this more comprehensive approach, then ISDA stands ready to co-operate and provide technical assistance where possible and appropriate in connection with that undertaking.

In our comments that follow, we have focused in the first instance on four issues: (1) legal enforceability; (2) form of the contract, and the importance attached to the form and substance of ISDA documentation and the standardisation achieved by trading with Russian counterparties in reliance on ISDA terms; (3) close-out netting; and (4) related collateral arrangements and other forms of credit enhancement. At a very general level, the interest and likely reaction of the broader ISDA membership to the draft Federal Law on Derivatives is relatively easy to anticipate and express: ISDA members will seek confirmation that the provisions, including the close-out netting mechanic, found in the ISDA Master Agreement and supporting collateral arrangements will be enforceable (i) by the Russian courts, (ii) in accordance with the agreement's terms, (iii) pre-insolvency and post-insolvency and (iv) whether any original transaction was to be cash-settled or would have been physically-settled (and whether deliverable or non-deliverable).

In this regard, we would comment in more detail as follows:

- I. **Legal enforceability.** In light of uncertainty arising from past decisions of Russian courts, derivatives market participants will take great comfort from a clear and unequivocal statutory recognition that derivatives trading under contracts, like ISDA's Master Agreements, will not be characterised as gambling and will be enforceable by Russian courts.
 - A. We have seen a proposed amendment to Article 1062 of the Civil Code of the Russian Federation to this effect ("forward transactions shall be entitled to legal defense on general terms") and query the current status of this proposal.
 1. Although the Federal Law on Derivatives purports to establish the legal status of derivatives (*Art 1*) and would take precedence over any other legislation in derivatives, including the Russian Federation Civil Code (*Art 2.1 and 2.2*), there does not appear to be a comparable explicit acknowledgement that qualifying derivatives contracts are enforceable in Russian courts and shall not be void by reason of any Russian law relating to games, gaming or lotteries (*cf. ISDA's Model Netting Act at Part 1, Section 3 - please see attached*).
 2. This issue is particularly acute in respect of so-called NDFs ("non-deliverable forwards").
 - a. In this case, the uncertainty stems in part from the exception from the protections of the Federal Law on Derivatives for "rights arising from betting or gaming" (*Art 4.5.7*).
 - b. It is our understanding that the intention is not to exclude NDFs and similar derivatives from the protections of the Federal Law on Derivatives, but our members will wish to have confirmation of this fact. Accordingly, we would recommend that the enforceability of NDF trading (as contemplated by ISDA terms when used in conjunction with ISDA Master Agreements) is recognised expressly.
 - B. You will also wish to consider whether your definition of a "derivative" (*Arts 3-5 and 7-8*) is flexible enough to accommodate, without the need for statutory reform, future innovation in such a dynamic market. In this regard, your attention is drawn to the flexibility provided for in Part 1, Section 2 of ISDA's Model Netting Act, which provides for a delegation of authority to the Central Bank (or another appropriate body) to designate over time by notice additional "derivatives" entitled to the protections of the act.
- II. **Form of the contract.** There may be concern among ISDA members that the Federal Law on Derivatives requirement (*Art 6*) that a derivatives contract be (i) a single document, (ii) signed by two authorised representatives and (iii) made in a simple written form may give rise to dispute and litigation and pose a

trap for the unwary. ISDA members will wish to confirm that ISDA documentation, which is modular in its architecture, sophisticated (and arguably complex as a result) and supplemented when each transaction is completed by the related confirmation of that transaction, qualifies. The two-signature, due-authorisation requirement needs to be sensitive to the way in which individual trades are transacted; due authorisation is also usually a matter of local law and corporate governance and a counterparty should be entitled to rely on apparent authority (*see Art 6 and in particular clauses 1 and 2*).

III. **Close-out netting.** A key issue, insofar as ISDA members are concerned, is that netting will be recognised and enforced in accordance with the terms of the parties' contract.

A. The draft Federal Law on Derivatives explicitly recognises the legality of close-out netting, but only “if not set otherwise by law or regulations” (*Art 13*). We have seen a draft Law on Set-Off (Netting) of Financial Obligations but are uncertain as to the status of this proposal. Is any particular law or regulation contemplated that will override the netting provisions that ISDA has published? How will any inconsistencies be resolved in light of Article 2.2, which would seem to provide that the Federal Law on Derivatives will override norms that do not comply with the Federal Law on Derivatives?

B. In addition, the law states that “rules for termination of obligations by netting shall be established by law” (*Art 13*). Market participants who are engaged in derivatives transactions pursuant to the ISDA Master Agreement will be concerned that Article 13 seems to subordinate provisions of the contract to potentially differing statutory requirements.

IV. **Collateral arrangements.** Collateral arrangements and title transfer provisions are viewed by the markets as significant risk mitigation tools but their relevance to a particular transaction is fact specific. When outlining significant terms of a derivative, the draft legislation seems to contemplate the provision of collateral or security as a standard term (*Art 7.2*), although this may have significant operational and cost consequences. While margining may be commonplace for exchange-traded products, is it intended that it will be required for over-the-counter trading as well (and, if so, on what basis)?

Although the issues discussed above are of particular importance, we offer for your consideration the following additional points of detail:

V. **Licensing requirements.** The draft Federal Law on Derivatives imposes a licensing requirement for derivatives transactions in which the underlying asset is a regulated asset (*Art 11.3*). However, the list of regulated assets is rather extensive (*Art 4.4*) so it is likely that licenses will often be required. These licensing rules and procedures need to be clear and understandable. The consequences of failing to comply with licensing requirements should not penalise the innocent counterparty. (*See, e.g., Art 11.3* - What are the consequences (and remedies) for an agreement that is deemed not to have been made for lack of license where one or both parties have partially performed their contract?)

VI. **Early termination.** The close-out netting mechanic of the ISDA Master Agreement is premised on a party's right to terminate scheduled payments and deliveries by designating an early termination date following a contractually-agreed triggering event of default or other termination event. The draft Federal Law on Derivatives provides for full or partial termination on grounds set out in that law, the Russian Federation Civil Code *or as agreed by the parties* (*Art 10.1*) and accelerated termination as set out by federal laws, rules of the marketplace *or as agreed by the parties* (*Art 10.2*). This would appear to recognise expressly the parties' right to provide for this issue in their written agreement, and will be welcomed by the market. However, no order of priority is given for reconciling the various sources in the event that they are inconsistent, and ISDA members will be concerned if this matter would be governed other than by the express terms of their contract in that event.

VII. **Disclosure.** Much attention is given in the draft law to requirements for notice and disclosure. The relative merits and costs associated with this regime warrant further consideration. If there is interest in doing so, ISDA would be happy to share with you the experience from other jurisdictions where attempts have been made to strike an appropriate balance on this issue.

- VIII. **Definition of marketplace.** The draft Federal Law on Derivatives frequently uses the term “marketplace” (see, e.g., Arts 9 and 20). But ISDA members will wish to clarify whether this term refers to organised exchanges only or to a more general, encompassing concept of the broader derivatives market involving counterparties in Russia, including over-the-counter trading. Similarly, references to “derivatives market” are ambiguous. It would be helpful to have clarification as to which provisions are meant to apply directly to the over-the-counter markets, in which event ISDA may be able to provide further comment for your consideration. Article 9.2, for example, seems to contemplate a mandatory term for contracts formed “outside a marketplace,” but it is not clear whether this requirement applies to over-the-counter trading governed by ISDA terms and, if it does, what the implications of this requirement for such trading could be.
- IX. **Extraordinary situations.** Market disruption and other changed or extraordinary circumstances have been given detailed attention by ISDA working groups (especially since the terrorist attacks of September 11, 2001 – “9/11”) as reflected in current ISDA documentation. The approach reflected in Article 36 of the draft Federal Law on Derivatives is not entirely consistent with the consensus reached by ISDA members on these issues. Our particular concern about the proposed statutory procedures for “extraordinary situations” is the tension these give rise to with the contractually agreed fallbacks for force majeure events in ISDA’s new 2002 Master Agreement and for market and settlement disruption terms that ISDA has published, or that parties have otherwise agreed, for specific markets. The introduction of a “Force Majeure Event” was among the more significant changes reflected in the 2002 Master Agreement, and followed the protracted review by the markets of relevant lessons from “9/11” and other unexpected changed circumstances. One of the key concerns was that certain events should be subject to a waiting period and not give rise to an immediate right to terminate affected trades. Another important innovation was the right to elect to terminate some but not all affected transactions and related anti-abuse provisions. In short, these provisions reflect a carefully crafted consensus as to how the market would wish to proceed in extraordinary situations, especially where there is a crisis that affects trading or settlement across borders. There will be concern if the Russian statutory scheme requires a different result, unless the parties’ contract can override that result.

We hope that our comments are helpful to you during your considerations. ISDA wholeheartedly endorses the spirit underlying your efforts to provide a robust statutory framework and greater legal certainty for the Russian Federation. We will be very glad for the opportunity, as the legislative process progresses, to work closely with you to address those issues we have identified. Any questions or requests for further information on the points raised in this letter should be directed to the undersigned at the ISDA New York Office, 360 Madison Avenue - 16th Floor, New York, NY 10017 (Tel. +1 212 901 6000; rpickel@isda.org) or to Peter Werner, ISDA’s Assistant Director of European Policy, at the ISDA European Office, One New Change, London EC4M 9QQ (Tel. +44 20 7330 3550, pwerner@isda-eur.org).

Yours sincerely,

Robert Pickel
Executive Director and Chief Executive Officer
International Swaps and Derivatives Association, Inc.