

‘REPORTING’ AS A MANDATORY CONDITION OF CLOSE-OUT NETTING

Abasheeva E., Teplova I.
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The operation of close-out netting in Russia became possible in 2011 after the adoption of amendments¹ to Federal Law No. 127-FZ, dated 26 October 2002, ‘On Insolvency (Bankruptcy)’ (hereinafter, the Bankruptcy Law). The enforceability of this mechanism depends on the compliance with a number of formal requirements. According to sub-clause 2 of clause 3 of Article 4.1 of the Bankruptcy Law, one of the conditions of the close-out netting is posting an entry on concluding a financial contract to the register maintained by a self-regulatory organisation of professional securities market participants, a clearing organisation or an exchange in line with the procedure envisaged by Article 51.5 of Federal Law No. 39-FZ, dated 22 April 1996, ‘On the Securities Market’² (hereinafter, the Securities Market Law).

It is believed that by incorporating the above requirement in the law, the lawmakers sought to prevent bankruptcy-related fraud, primarily in the form of concluding backdated contracts, by allowing the operation of close-out netting only with regard to those contracts the details of which have been preliminary disclosed by the parties³ thereto.

It should also be noted, that the dependence of civil transaction feasibility on the time such transaction is reported to a repository seriously impedes the application of close-out netting under the Russian law. Besides, the analysis of ISDA opinions on the close-out netting operation suggests that developed jurisdictions do not regard reporting for regulatory purposes as a mandatory condition of close-out netting⁴.

¹ According to Article 6 of Federal Law No. 8-FZ, dated 7 February 2011, ‘On Amending Certain Laws of the Russian Federation in Connection with the Adoption of the Federal Law ‘On Clearing and Clearing Activities’ // RLS Consultant Plus.

² The emergence of the so-called ‘repositories’ was driven by the decisions of the G20 Pittsburgh Summit concerning first-priority measures to improve the over-the-counter derivatives market, which specifically include the following: all OTC derivative contracts should be reported to special infrastructure organisations, i.e. trade repositories.

³ This view is shared, for example, by Simkovic M., who points to the feasibility of registering OTC contracts for the purpose of close-out netting: “arguing that creditors seeking priority in bankruptcy need to be forced to disclose publicly their claims in full and that Congress should establish a universal “recordation” system for any instrument that gives a creditor greater priority than that of a general unsecured creditor”, *Secret Liens and the Financial Crisis of 2008*, p. 289-290, quote from: Johnson V. “International Financial Law: the Case Against Close-out Netting”, *Boston University International Law Journal* (available at: <http://www.bu.edu/ili/files/2Q15/04/Johnson-The-Case-against-Close-out-Netting.pdf>).

⁴ See, for example: Memorandum of law for the ISDA, Inc on Validity and Enforceability under English Law of Close-out Netting under the 2002, 1992 and 1987 ISDA Master Agreements, prepared by Allen & Overy LLP, 2014 (available for ISDA members at: http://www.isda.org/docproj/netpdf/2014_English_Law_ISDA_Netting_Opinion.pdf); Memorandum of law for the

The authors of UNIDROIT Principles⁵ arrived to the same conclusion in Principle 5, asserting that the implementing State's legislation shall not make the operation of close-out netting provisions and obligations covered by such provisions dependent on the compliance with formal requirements, including any requirement to report data to a state body or a self-regulatory organisation.

Therefore, taking into account international practices, it seems reasonable to gradually abandon the 'reporting' requirement as a mandatory condition for the operation of close-out netting. To that end, it shall be practicable to make non-compliance with the requirement to report information to a repository subject only to administrative sanctions (e.g., fines), and not to allow such non-compliance influence the enforceability of close-out netting.

In order to eliminate the above concerns with regard to bankruptcy-related fraud, the parties should employ civil methods, including means to challenge contracts, for the protection of their rights. This approach was also used in Principle 6 of UNIDROIT Principles⁶.

Coming back to discussing the existing regulation of 'reporting' and close-out netting raises the issue of additional problems experienced by market participants because of the 'reporting' mechanism. This mechanism was established by Bank of Russia Ordinance No. 3253-U⁷. The main problem consists in the fact that, as per clause 24 of the above mentioned Ordinance, market participants' reports under the bilateral 'reporting' mechanism are entered into the register, envisaged by Article 4.1 of the Bankruptcy Law, only after the properly executed 'matching' procedure, i.e. the matching of fields, subject to verification, from the reporting forms submitted by the parties to a contract (informing parties).

ISDA, Inc on Validity and Enforceability of Close-out Netting under the 2002, 1992 and 1987 ISDA Master Agreements in German Law, prepared by Hengeler Mueller, 2014 (available for ISDA members at: http://www.isda.org/docproj/netpdf/Germany_Netting_July0714_TR_Web.pdf).

⁵ Principles to be followed by lawmakers when developing close-out netting provisions. UNIDROIT, 2013 (available at: <http://www.unidroit.org/english/principles/netting/netting-principles2013-e.pdf>.)

⁶ "Principle 6...

2) These Principles do not render enforceable a close-out netting provision or an eligible obligation that would otherwise be unenforceable in whole or in part on grounds of fraud or conflict with other requirements of general application affecting the validity or enforceability of contracts" // (available at: <http://www.unidroit.org/english/principles/netting/netting-principles2013-e.pdf>.)

⁷ Bank of Russia Ordinance No. 3253-U, dated 30 April 2014, 'On the Procedure for Keeping a Register of Agreements Concluded under the Master Agreement (Single Agreement), Deadlines for the Provision of Information Required for the Said Register and Information from the Said Register, as well as Presenting the Register of Agreements Concluded under the Master Agreement (Single Agreement) to the Central Bank of the Russian Federation (Bank of Russia)'// RLS Consultant Plus.

The ‘matching’ requirement is dictated by regulatory purposes. However, the use of ‘matching’ in the framework of close-out netting creates the setting, where the right of a complying party, which has duly reported information to the repository, will always depend on the actions of the other party which may either fail to provide information, or may report distorted information, thus making the implementation of close-out netting provisions totally impossible.

Besides, the said procedure exerts an indirect and additional pressure on foreign parties to cross-border transactions executed in the financial market. According to clause 1.1 of Bank of Russia Ordinance No. 3253-U, foreign parties to cross-border transactions in the financial market are not obliged to submit information to a repository (when such transactions are concluded with the Russian parties, listed in clause 1.1 of the above mentioned Ordinance, respective information is unilaterally reported by these parties). However, because of direct relations existing between regulatory reporting and close-out netting, foreign parties, acting on their own, are forced to voluntarily report this information to mitigate potential counterparty risks. Besides, the time lag between the moment of transaction conclusion and the moment respective information is entered in the register creates additional legal risks for the parties.

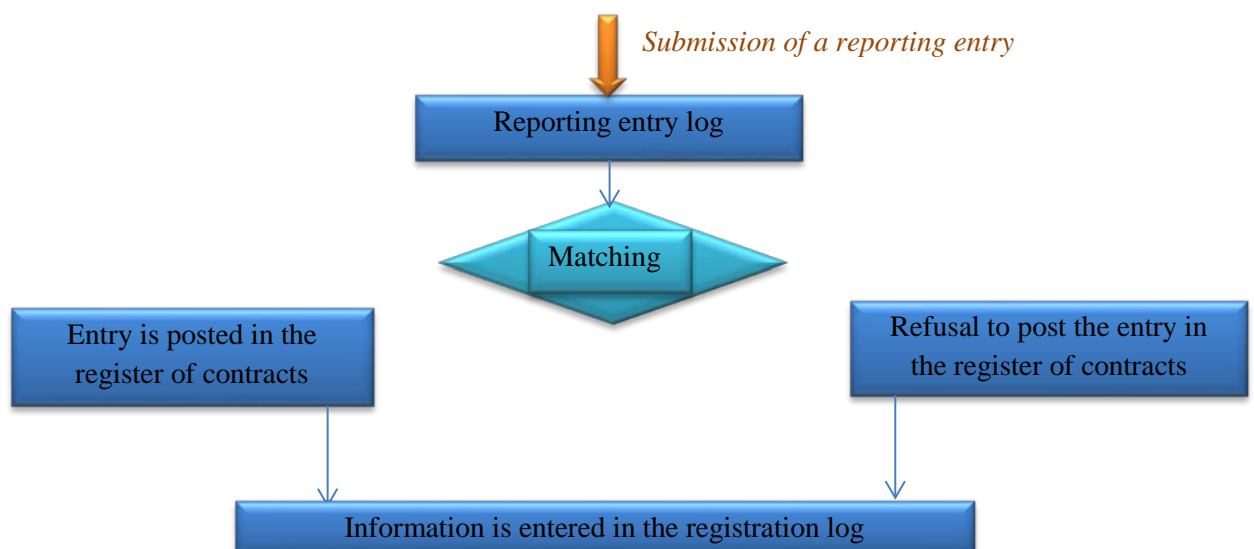
The Bank of Russia Ordinance No. 3253-U in the version amended by Bank of Russia Ordinance No. 3567-U⁸, as compared with the previous one⁹, has been amended in what concerns the part under consideration. The Ordinance no longer includes priority provisions (for the purpose of establishing close-out amount following the termination of liabilities under financial contracts) with regard to information from the contract register of the repository over other (initial) documents related to such contracts. Besides, for the purpose of close-out netting, clause 34

⁸ Bank of Russia Ordinance No. 3567-U, dated 16 February 2015, ‘On Amending Bank of Russia Ordinance No. 3253-U, Dated 30 April 2014, ‘On the Procedure for Keeping a Register of Agreements Concluded under the Master Agreement (Single Agreement), Deadlines for the Provision of Information Required for the Said Register and Information from the Said Register, as well as Presenting the Register of Agreements Concluded under the Master Agreement (Single Agreement) to the Central Bank of the Russian Federation (Bank of Russia)’ // RLS Consultant Plus.

⁹ Bank of Russia Ordinance No. 3253-U, dated 30 April 2014, as amended by Bank of Russia Ordinance No. 3392-U, dated 17 September 2014, ‘On Amending Bank of Russia Ordinance No. 3253-U, Dated 30 April 2014, ‘On the Procedure for Keeping a Register of Agreements Concluded under the Master Agreement (Single Agreement), Deadlines for the Provision of Information Required for the Said Register and Information from the Said Register, as well as Presenting the Register of Agreements Concluded under the Master Agreement (Single Agreement) to the Central Bank of the Russian Federation (Bank of Russia)’ // RLS Consultant Plus.

of the Ordinance sets out the requirement to timely report only the fact of concluding a respective contract.

It should be noted that on 7 September 2015, the Bank of Russia adopted Ordinance No. 3776-U¹⁰ (hereinafter, Bank of Russia Ordinance No. 3776-U) on amending its Ordinance No. 3253-U. Among other things, the newly adopted Ordinance cancels the ‘matching’ requirement for information reported for the purpose of close-out netting. According to clause 35 of Bank of Russia Ordinance No. 3253-U, as amended by Bank of Russia Ordinance No. 3776-U, the close-out netting operation only requires that the reporting entry about a contract conclusion be registered by a repository in the reporting log, which, in its turn, is an integral part of the register. Reporting entries are included in the log irrespective of the existence/absence of a counter reporting entry made by the other party to the contract (informing party) before the ‘matching’ procedure. Therefore, reporting entries are posted in the log notwithstanding the fact, whether reporting information submitted by both parties to the contract match each other. The procedure of registering reporting information by the repository is presented in the following scheme below:



¹⁰ Bank of Russia Ordinance No. 3776-U, dated 7 September 2015, ‘On Amending Bank of Russia Ordinance No. 3253-U, Dated 30 April 2014, ‘On the Procedure for Keeping a Register of Agreements Concluded under the Master Agreement (Single Agreement), Deadlines for the Provision of Information Required for the Said Register and Information from the Said Register, as well as Presenting the Register of Agreements Concluded under the Master Agreement (Single Agreement) to the Central Bank of the Russian Federation (Bank of Russia)’ // RLS Consultant Plus.

Thus, as an interim variant to solve the aforementioned problem of mitigating the risks faced by parties to the process, the Bank of Russia decided to exclude from its Ordinance No. 3253-U the ‘matching’ requirement with regard to close-out netting. This measure will help the complying party, which has reported information to the repository on time, avoid the dependence on the counterparty’s actions.

However, the positive effect of these changes is for the most part eroded by the requirement of the law to submit repository reporting for the purpose of close-out netting. In view of the above, it seems reasonable to introduce respective amendments to Article 4.1 of the Bankruptcy Law, which will eliminate the legal uncertainty in what concerns the exclusion of the ‘reporting’ requirement as a mandatory condition for the enforceability of close-out netting¹¹.

¹¹ “The necessity to improve the existing regulatory framework of close-out netting under Russian law has been confirmed by the ISDA netting opinion on Russia published in February 2015. This opinion contains conclusions on the possibility of close-out netting operation with regard to cross-border transactions under ISDA Master Agreement. Notwithstanding the overall positive character of the Opinion, its thorough analysis suggests that the existing legal framework regulating close-out netting calls for its further improvement in line with international standards and best law enforcement practices”. Quote from: Abasheeva E.N./Абашеева Е.Н., Teplova I.V./Теплова И.В. Contractual Liability is Terminated by Close-out Netting. Regulatory Pluses and Minuses/ «Договорное обязательство прекращается ликвидационным неттингом. Плюсы и минусы регулирования», *Arbitrazhnaya Praktika/ Арбитражная практика*, No. 8, 2015.