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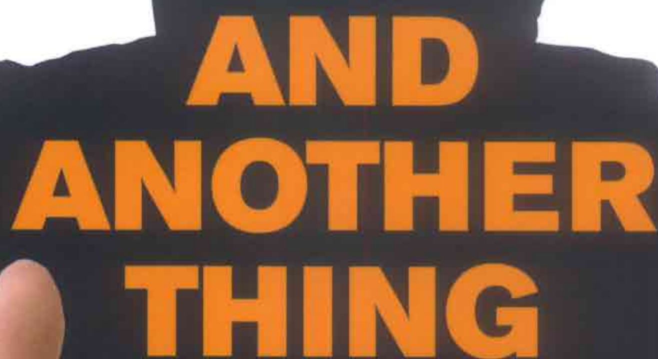

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Examine the potential reach of Russian legislation carefully before structuring cross-border deals

Although a number of Western companies already have a well-established presence in Russia, many banks are cautious about entering this part of the world. Attracted by the tremendous opportunities in the Russian markets, but fully aware of the risks involved, these banks prefer not to set up a local office, but rather to operate off-shore. Despite the fact that one or even all counterparties to the deal may be located outside the Russian Federation, and therefore be outside Russian jurisdiction, while negotiating and structuring these deals, it is wise to take into account the possibility of extraterritorial application of Russian legislation to this type of transaction, and, most importantly, to their Western participants.

This article provides an analysis of several possible cases of cross-border or offshore participation of Western banks in Russian markets where there is a possibility of extraterritorial application of Russian legislation. In all such cases, verifying that cross-border transactions comply with the requirements of Russian legislation will make it possible to avoid the costly consequences of their violation. Under certain circumstances, these could be as severe as the withdrawal of a banking licence from a bank by its home-country regulators, and its subsequent liquidation.

Offshore purchase of Russian assets

In the first case, a Western bank purchases Russian securities or other assets (tangible or intangible) located in Russia from a Western company, which could be either the direct owner or a person holding them in trust for their beneficial owner. Following the recent approval by the Swiss Parliament of the ratification by Switzerland of the Hague Convention on the Law Applicable to Trusts and on their Recognition of July 1 1985 (Hague Trust Convention), resulting in greater security of trust operations in Switzerland, Swiss companies acting as trustees in such transactions are expected to increase. The buyer and the seller are located outside Russia, and the respective purchase-sale agreement is entirely negotiated and executed outside its territory. Furthermore, the parties choose to govern this agreement by their national law or the law of the third country (usually, Swiss law or English law), thus, explicitly excluding the application of Russian law.

Despite all these efforts, the Western bank could still be affected by the extraterritorial application of Russian law. First, under certain conditions, this transaction could become subject to recent Russian competition law, including its requirement to obtain a prior consent of the Federal Antimonopoly Service (FAS) for the purchase of securities, notably in cases when the agreement "leads or could lead to the restrictions of competition in the Russian Federation" (Article 3(2) of Federal Law 135-FZ On Competition, July 26 2006). Should the Western bank fail to consider the possible impact on the purchase-sale agreement on the competition in Russian markets, it runs the risk of Russian courts declaring this transaction void at the request of FAS. Since the company keeping the registry of purchased securities or, as the case may be, other assets are themselves located in the territory of the Russian Federation, FAS would have no difficulty in enforcing this court decision.

Second, in addition to the application of Russian competition law, the off-shore transaction for the purchase of Russian securities may be affected by various requirements of Russian currency control laws. The Western bank should be aware that when securities denominated in Russian roubles, the issuance of which is registered in the Russian Federation (the so-called internal securities), were bought by their original purchaser prior to July 1 2006, in order to make the payment in favour of the Russian seller this purchaser will have used a special rouble account opened in an authorized bank in the Russian Federation, and the payment itself will have been in Russian roubles (see Article 8[8] of the Federal Law 173-FZ On Currency Regulation And Currency Control December 10 2003; sections 4.1.1.-4.1.4. of Instructions 116-I of the Central Bank of the Russian Federation, Concerning The Types Of Special Accounts Of Residents And Non-Residents June 7 2004). On the other hand, when the original purchaser bought the external securities (defined by Russian currency control law as all securities other than internal securities) in the course of their initial offering, prior to July 1 2006, it would have made the payment in foreign currency to a special account in the authorized bank in the territory of the Russian Federation (section 2.1 of Instructions 116-I).

> **"Given human ingenuity in structuring cross-border transactions, a bank should always consider the compliance of the initial purchase with Russian legislation"**

Taking into account the scope of human ingenuity in structuring cross-border financial transactions to avoid existing statutory restrictions, when buying Russian securities offshore, a Western bank should always consider the initial purchase within these requirements of Russian legislation. Should the Western bank fail to conduct such due diligence, it runs the risk that the underlying transaction may be considered by Russian administrative authorities as null and void, even in the absence of a court decision. The Western bank may then face protracted litigation concerning the legality of acquiring securities from a person who did not have the right to sell them in the first place.

Unlike the previous Russian law on currency regulation and currency control of October 9 1992, the new law does not contain a specific reference to the nullification of a transaction which violates the currency control rules. Nevertheless, such transactions may still be viewed as null and void by Russian currency control authorities on the basis of general provisions of Russian Civil Code (see Articles 166-168 of the Civil Code). Once again, if the company keeping the purchased securities is located in the territory of the Russian Federation, Russian authorities will have no difficulty in declaring the nullity of the respective transaction and enforcing the consequences of such nullity.

Financing concession agreements

Western banks may be tempted to use cross-border deals related to financing concession agreements as outlined by Russia's recent law, in order to address several restrictions which may seem problematic from the point of view of a foreign financier. These restrictions include that a concessionaire is not allowed to encumber a concession object with a mortgage nor to pledge its rights under the concession agreement, including mortgaging and pledging in favour of a bank providing loans for the project (see Articles 3(6) and 5(2) of Federal Law 115-FZ On Concession Agreements July 21 2005).

In an attempt to circumvent these and several other restrictions imposed by Russian law, a Western bank may resort to entering into the mortgage or pledge agreement with a concessionaire not governed by the law of the Russian Federation, but by the law of a country which does not prohibit making such encumbrances. Nevertheless, since the concession object is located in the territory of the Russian Federation, the Western bank should be aware that in the event of a dispute it is highly unlikely that the choice of an applicable law will be upheld by a Russian court. Under the Russian law any such pledge or mortgage in favour of a Western bank would be considered as null and void.

Cross-border securitization deals with Russian assets

In this case, a Russian originator of a securitization deal enters into an agreement with a Western company (an SPV), to which it assigns

all of its domestic receivables (a so-called true-sale securitization). For its part, the Western bank enters into an agreement with the SPV to buy bonds issued by this company or to grant this company a loan to finance the purchase of the receivables. Although the Western bank does not have any contractual relations with a Russian originator of the securitization deal, and its agreement with the SPV normally would be governed by non-Russian law, it still could be affected by an indirect effect of the application of Russian law.

First, despite a number of recent Russian court rulings in favour of the partial assignment of rights, this issue as well as the possible assignment of future rights, (such as rights to future receivables) under Russian law is far from being settled. Should Russian courts consider the respective assignment of receivables as null and void, it would directly affect the capacity of the SPV to fulfil its obligations to the Western bank under its bonds or a loan agreement with the bank.

Second, in an attempt to dispel possible doubts about the assignability of domestic receivables under Russian law, the Russian originator of the securitization deal and the SPV may decide to subject their deal to a foreign law (such as English or Swiss law), taking a more favourable view towards such an assignment. Although Russian Civil Code expressly provides for the possibility of choosing applicable laws in international commercial transactions, it specifically submits the issue of assignability of receivables to the same law, which governs the respective receivables (see Article 1216 of Russian Civil Code). As a result, by opting in favour of the application of foreign law to the assignment of domestic receivables, the parties (and the Western bank, respectively) risk that in the event of a dispute this choice of applicable law will not be upheld by Russian courts, resulting in the nullification of the underlying transaction.

Thus, a Western bank entering into an offshore securitization transaction involving Russian assets, may wish, as a precautionary measure, to carefully look into the terms and conditions of the underlying assignment and its validity under Russian law.

Cross-border trust management of Russian securities

In this case, the Western bank enters into an agreement with a Western company or private individual which owns Russian securities to exercise trust management of these securities in the bank's name. The respective trust management agreement is entirely negotiated and executed outside the territory of the Russian Federation, and is governed by non-Russian law. Nevertheless, the Western bank should be aware that under Russian law trust management of securities is considered as one of the types of professional activities in the securities market that is subject to a mandatory licensing by the Federal Financial Markets Service (FFMS). Taking into account that trust management of securities in the territory of the Russian Federation without a licence is illegal (except for the cases when this activity does not go beyond a simple exercise of rights under the securities), the Western bank involved in such activities may be subject to sanctions prescribed by Russian law, including the possibility of becoming an object of a court action brought by FFMS to relinquish ill-gotten profits (see Articles 5 and 51(6) of the Federal Law 39-FZ On Securities Markets April 22 1996).

Lawyers need to make sure they avoid running into the long-armed and sharp reach of Russian regulation

Opening of foreign banking accounts to Russian persons

In this case, a private Western bank enters into an agreement with a Russian company (usually, a law firm or a services company). Under the agreement, this Russian company undertakes to locate wealthy individuals or companies, offer them an account at the respective Western bank outside the territory of the Russian Federation (normally in Switzerland), and if they agree, to make them complete all required banking forms and documents and to send these completed documents back to the bank.

Although the officials of the Western bank may not be present on the territory of the Russian Federation, such a structure could still result in a violation of the Russian law on banks and banking activities. This law explicitly prohibits opening banking accounts and making bank deposits on the territory of the Russian Federation without a licence from the Central Bank of the Russian Federation (see Federal Law No. 395-I *On banks and banking activities* December 2 1990). As a result, the Western bank runs the risk that the respective activities of its intermediary may be viewed by the Russian authorities as activities of the bank itself, amounting to banking activities on the territory of the Russian Federation without a required licence.

The possible consequences of such a violation for a Western bank could be best illustrated, perhaps, with the example of Switzerland, a country that attracts the attention of those dealing with Russian assets and clients. Under Swiss banking law, banks operating in Switzerland should always present guarantees of irreproachable activity (see Article 3(2)(c) of Federal Law *On banks and saving institutions*, November 8 1934). According to the Swiss Federal Banking Commission, the violation of provisions of a foreign law governing banking activities, the equivalent of which may be found in the Swiss law, could mean the non-observance of guarantees of irreproachable activity, and may be considered grounds for withdrawing a banking licence from a Swiss bank. Swiss banking law explicitly prohibits the conduct of banking activities without a preliminary authorization (see Article 3(1) of the law). Consequently, having discovered this structure, Russian authorities may inform the home-country regulators of the respective bank, which, in the case of Switzerland, could result in an eventual closure of the bank.

The above indications are by no means intended to discourage an active participation of Western banks in profitable Russian markets, using cross-border or off-shore transactional structures. What is crucial in making such participation truly successful, however, is a careful consideration of possible extraterritorial application of Russian legislation to the proposed transaction, and taking its requirements into account when structuring and negotiating the respective deal.

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