New law marks departure for exchange control

Russia's new law on currency regulation and control provides unprecedented opportunities and flexibility in structuring cross-border transactions and investments. Sergey B Komolov of Hogan & Hartson outlines the changes

On June 18 2004, the Russian federal law 173-FZ "On Currency Regulation and Currency Control" came into effect. The new law, which is not fully understood or appreciated yet by many market participants, introduces a model of regulation in the area of exchange control that is a radical departure from the one prevailing under the previous law on currency regulation and control, dated October 9 1992 (the 1992 law). Under the 1992 law, no foreign entity or individual could invest in Russia or provide financing to a Russian company without making sure that a myriad of complex exchange control rules and regulations were observed along the way. Fines and other sanctions against violators could be steep.

In this respect, the new law provides some needed relief. The 1992 law included a closed list of transactions with *foreign currency valuables* that were expressly allowed, and any other transactions were prohibited unless specifically, on a case-by-case basis, permitted by the Russian central bank. The new law authorizes, on an unrestricted basis, all kinds of transactions with foreign currency valuables between Russian residents and non-residents except for a limited list of transactions that can be subject to special regulation (but not prohibition) through a requirement to use a special bank account and/or to deposit rouble funds in escrow against a particular transaction.

Definitions

Securities are now divided into internal securities (investment securities such as shares of stock and bonds denominated in roubles, which are registered in Russia, and also other securities issued within Russia that certify the right to receive roubles) and external securities. This terminology is more narrow and focused than that used in the 1992 law, which spoke about securities (defined to include payment instruments, investment securities, derivatives on investment securities, options on investment securities and other debt obligations) denominated in the currency of the Russian Federation and securities denominated in a foreign currency. On strict reading of the new law, trading in ownership interests in limited liability companies, various derivatives and debt obligations, which do not fall under the Russian law definition of securities, should no longer be subject to exchange control regulation.

The definition of *currency valuables* now includes only foreign currencies and external securities, whereas in the 1992 law this definition included also precious metals and natural gemstones.

The new law limits the scope of regulated *currency transactions* to: (i) purchase and sale of currency valuables; (ii) transfers of roubles and internal securities between residents and non-residents; and (iii) transfers abroad or from abroad of currency valuables, roubles or internal securities. Under the 1992 law, all transactions related to transfers of ownership and other rights to currency valuables were considered to constitute currency transactions, but the new law is concerned only with purchase and sale of currency valuables and, in certain instances, internal securities and with cross-border movement of currencies and securities.

A limited list of transactions can be subject to special regulation through a requirement to use a special bank account and/or to deposit rouble funds in escrow

The 1992 law created serious impediments, for example, to trading debts and other foreign currency receivables, to clearing and set-off of mutual debts expressed in foreign currencies and to using currency valuables as collateral as far as Russian companies were concerned. The narrow definition of currency transactions in the new law is expected to help in all those areas.

In furtherance of the new model of regulation, the new law introduces definitions of *special account* (which can be a money account at an authorized Russian bank or a custody account for securities) and *passport of transaction*, which is now required for most types of foreign currency transactions.

Powers of exchange control authorities

The new law has substantially narrowed the powers of regulatory authorities in the area of exchange control (the government and the Central Bank of Russia). In general, they are now reduced to establishment of reserve (escrow deposit) requirements and requirements to use special accounts for certain types of currency transactions. The government and the central bank can no longer introduce requirements and prohibitions applicable to transactions that are not directly named in the new law as being susceptible to restriction and can no longer issue transaction-specific permissions.

The new law assigns enforcement of compliance (currency control) in Russia to the Russian government, the Central Bank of Russia, federal executive bodies authorized for this purpose by the government and agents of currency control. The latter include authorized Russian banks, other professional participants of the securities market (including licensed registrars) and regional offices of the federal executive bodies authorized to act as bodies of currency control. Under the 1992 law, only authorized banks could act as agents of currency control. All of this suggests that, while liberalizing the regulatory model, the lawmakers intended the remaining restrictions to be enforced more vigorously and moni-

Sergey B Komolov

Hogan & Hartson LLP

Sergey Komolov is a partner in the Moscow office of international law firm Hogan & Hartson LLP, practising in the areas of public and private finance, corporate acquisitions, investment and commercial banking, securities and derivatives trading, bank and corporate restructurings, and general corporate and transactional advice. His clients include some of the biggest Russian corporations. Before joining Hogan & Hartson in 2000, he served as general counsel to United Export Import Bank, one of the largest Russian financial institutions, and worked at the legal department of the World Bank in Washington DC. Before practising law, Komolov had a distinguished career in the Russian diplomatic service. He received a diploma in international law with distinction from the Moscow State Institute for International Relations (MGIMO University) Law School and an LLM with honours from Georgetown University. He is admitted to practise law in Russia and in the State of New York.

Peter J Pettibone

Hogan & Hartson LLP

Peter Pettibone is the managing partner of the Moscow office of Hogan & Hartson LLP, and head of the firm's Russia practice. Pettibone has 30 years' experience in US-Russian trade and investment and has handled some of the more significant projects in the region. His practice is primarily corporate and focuses on general corporate advice to US and other western companies engaging in business in the Russian market, as well as advice to Russian companies seeking to conduct transactions in the west. In addition, Pettibone has extensive experience in cross border transactions, including financing equipment sales and leases, ADR issuances, debt and equity financings, mergers and acquisitions, and corporate restructurings and recapitalizations. Pettibone represented Dennis Tito and Mark Shuttleworth in their negotiations with the Russian space agencies to fly to the International Space Station on a commercial basis.

Pettibone received an AB from Princeton University in 1961, *summa cum laude*, his JD from the Harvard Law School in 1964 and an LLM from New York University in 1971. He is a member of the New York, Pennsylvania and District of Columbia Bars.

toring of compliance to become more pervasive.

Permitted foreign currency transactions

According to the new law, all currency transactions are carried out without restriction except for some operations included in a closed list, which can be expanded only through an amendment to the law itself.

In the 1992 law, currency transactions were divided into current operations (in particular, export and import of goods and services) and those connected with movement of capital (in particular, investments and credits). Whatever was not specifically mentioned in the 1992 law as a current transaction was automatically regarded to be a capital transaction. Current transactions were allowed without restriction, but for consummation of capital transactions special permissions of the Central Bank of Russia or special entitling regulations of the central bank were required. These basic assumptions have been completely reversed by the new law.

By way of an example, Regulation of the Central Bank of Russia 82 dated July 20 1999, which was adopted pursuant to the 1992 law, established that, to receive a permission to make a contribution to the share capital of a non-resident financial company, a potential Russian investor was required to present to the Central Bank of Russia 13 documents, which were supposed to be considered within a month. Regulation 82 did not contain any criteria for making a decision whether to grant or refuse such a permission. Unless the applicant was a bank, these 13 documents should have included an opinion of the Ministry of the Economy about the possibility and expediency of such an investment. According to Order of the Ministry of the Economy 421 dated August 24 1999, to receive such an opinion, it was necessary to collect 14 documents, which were also supposed to be considered within a month. Criteria for making a decision about the possibility and expediency of an investment were not prescribed in Order 421 either. The end result was that Russian companies and individuals could not plan investments abroad with any degree of predictability.

In contrast, no permission of any kind is required for such operations under the new law, although the use of a special account and reservation (deposit into escrow) of a specified amount may be required.

The Russian government can introduce reservation restrictions with respect to certain types of operations, mostly those related to exports and imports and purchase by residents from non-residents of shares and other interests in the share capital of foreign legal persons. For these transactions, two types of reservation requirements are contemplated in the new law, depending on the nature of transaction. For some transactions, reservation of 50% of the amount of transaction for a period of up to two years can be introduced, and for others, reservation of 100% of the amount of transaction for a period of up to 60 calendar days. These two types of reservation requirements cannot be applied to the same transaction at the same time.

The Central Bank of Russia can introduce restrictions with respect to such types of operations as settlements under loan agreements and purchases and sales of external and internal securities. For these transactions, the new law makes it possible to introduce special accounts and reservation requirements. Reservation requirements – up to 20% for a period of up to one year or up to 100% for a period of up to 60 days – can be established by the Central Bank of Russia with approval of the government. These two types of reservation requirements cannot be applied to the same transaction at the same time.

It should be noted that for transactions with internal securities (such as shares of stock of Russian companies and rouble bonds) between residents and non-residents, the new law allows settlements only in roubles.

Foreign currency transactions among residents

As before, currency transactions among residents are forbidden, except for certain types of transactions included in a

closed list contained in Article 9 of the new law. Article 9 also sets out the list of currency transactions that can be carried out without restriction between ordinary residents and authorized Russian banks.

The new law grants to resident legal persons an opportunity to carry out among themselves currency operations with any external securities, but only on the condition that rights to such securities must be recorded by depositaries created according to the legislation of the Russian Federation, and also on the condition that settlements must happen in roubles. In practice, it is not quite clear how this rule will be applied to different types of securities. Probably, at the very least, investment securities (such as shares of stock and bonds) should be covered by the language of the new law, because the Russian federal law "On Securities Market" makes it clear that rights to investment securities can and must be recorded by depositaries.

An interesting situation arises with promissory notes. The new law considers promissory notes certifying the right to receive foreign currency (that is, containing a foreign currency effective payment clause) to be external securities and, therefore, currency valuables. Under Russian law, a promissory note is not an investment security and cannot exist in non-documentary form, and Russian depositaries, as a rule, do not record rights to promissory notes but only accept them for safekeeping. At the same time, Russian regulations governing depositary activities stipulate that the object of such activities (that is, recording and transfer of rights to securities) can be securities other than investment securities. At this stage, the issue of whether promissory notes that are classified as external securities can be traded among Russian residents remains unsettled.

While liberalizing the regulatory model, the lawmakers intended the remaining restrictions to be enforced more vigorously and monitoring of compliance to become more pervasive

Residents' bank accounts outside Russia

Under the new law, residents can freely open accounts in foreign currencies in countries that are members of the Organization for Economic Cooperation and Development (OECD) or the Financial Action Task Force (FATF). Russian tax authorities must be notified within a month after the account is opened. The new law makes it possible to open accounts in non-OECD and non-FATF countries as well, but only in accordance with a special procedure established by the Central Bank of Russia, which can include a preliminary registration requirement. In fact, under Regulation of the Central Bank of Russia 1411-U dated March 30 2004, there must be preliminary registration of rouble accounts opened in any foreign country and of foreign currency accounts opened in non-OECD and non-FATF countries.

Russian legal entities will be able to make use of this new freedom only after June 18 2005.

Implementing regulations

Subsequent to the entry into effect of the new law, the Central Bank of Russia issued a number of implementing regulations that clarify, in particular, how the special bank accounts will operate and which transactions carry with them reservation requirements.

Regulation 116-I dated June 7 2004 provides that, where one of the parties is a non-resident: (i) all foreign currency loans from and to resident individuals and settlements in connection with sales and purchases of external securities by resident individuals must be handled through such individuals' special foreign currency F accounts; (ii) all foreign currency loans to resident companies and certain purchases of external securities from resident companies must be handled through such companies' special foreign currency R1 accounts; (iii) all foreign currency loans from resident companies and sales of external securities to resident companies and certain purchases of external securities from resident companies must be handled through such companies' special foreign currency R2 accounts; (iv) all transactions with residents with government rouble bonds must be handled through non-residents' special rouble S accounts; (v) all transactions with residents with Russian company shares must be handled through non-residents' special rouble A accounts; (vi) all transactions with residents with corporate rouble bonds must be handled through non-residents' special rouble O accounts; (vii) all rouble loans from residents and certain sales of internal securities to residents must be handled through non-residents' special rouble V1 accounts; and (viii) all rouble loans to residents and certain purchases and sales of internal securities from and to residents must be handled through non-residents' special rouble V2 accounts.

Regulation 1465-U dated June 29 2004 establishes reservation requirements with regard to certain operations with special accounts R1, R2, S, O, V1 and V2. All deposits in compliance with reservation requirements must be made in roubles and do not bear interest. So far, reservation requirements do not seem to be particularly onerous, and operations with special accounts F and A are completely exempted.

Some practical implications

Although the terminology and methodology of the new law are rather complex, and certain provisions seem to be arcane, in reality the new law offers to both foreign investors and (especially) Russian companies and individuals unprecedented (by Russian standards) opportunities and flexibility in structuring cross-border transactions and investments. By using the right mix of instruments and currencies, an experienced practitioner can minimize or even eliminate altogether the need to use special accounts and to resort to reservation of funds. In principle, under the terms of the new law, even these remaining restrictions (that is, the need to use special accounts and to reserve funds) should fall away as of January 1 2007, whereupon Russia could be called a country without exchange control restrictions. With exchange control so closely tied to general economic conditions and stability of the rouble, though, everybody would be well advised to keep their fingers crossed with regard to the January 1 2007 target. Special accounts and reservation requirements may yet turn out to be more than a temporary measure.