

# Russian Civil Code Reform Continues: Episode 3

On 3 July 2013 further amendments to the Russian Civil Code were officially published (the "**Amendments**"). This is the third set of amendments enacted under the current programme of ongoing reform of Russia's civil legislation. The Amendments primarily affect provisions of the Civil Code dealing with securities. Although substantial in number, many of the Amendments are not entirely novel, but codify case law and existing business practices or reconcile general provisions of the Civil Code with those of specialised laws. That said, some of the Amendments do change the current rules.

This briefing touches upon the Amendments that appear to be the most important from a practical perspective.

## Summary of the Amendments

### Securities: general provisions

#### What is considered a security

The definition of the term "security" has essentially not been changed. As before, the term "securities" is confined to instruments which are named as such in law or have been characterised as such in accordance with the prescribed statutory criteria. Mortgage deeds and units of unit investment funds have been added to

the list of securities set out in the Civil Code, and a number of types of securities which were rarely used in practice have been removed from the list.

#### Differentiation of the regimes applicable to certificated and uncertificated securities

One anticipated amendment is the clear distinction that has now been made between certificated securities and uncertificated securities. Under the new classification certificated securities are things, while uncertificated securities are treated as "other property".

## Nota bene

- A set of rules is introduced aimed at protecting the rights of shareholders whose shares have been unlawfully debited from their account, including conditions under which such a shareholder may challenge resolutions adopted by other shareholders whilst the former was wrongfully deprived of its right to participate in management of the company.
- Debt securities and any securities acquired through an exchange cannot be recovered from a *bona fide* purchaser.
- Issuers cannot maintain registers of shareholders on their own.
- The course of action to be taken by a registrar in the event of loss of the register of shareholders is set out.

Under the general rule, provisions governing registered certificated securities, records of which are maintained by a registrar or custodian, also apply to uncertificated securities. At the same time, a new section dedicated exclusively to uncertificated securities and dealing with specific aspects of their regulation has been added to the Civil Code. In particular, rules have been introduced protecting holders of uncertificated securities in cases where the securities have been unlawfully debited from their accounts

(by analogy with the provisions on restitution of property unlawfully held by another person), and conditions are set out under which such securities cannot be recovered from *bona fide* purchasers.

### **Certificated securities**

The Amendments clarify the legal effect of an instrument that does not meet the formal requirements for being a security: while not qualifying as a security, such instrument still constitutes written evidence. Also, provisions have been introduced on counterfeiting and forgery of securities.

Procedures governing the recovery of certificated securities from unlawful possession have been added (general rules on restitution set out in the Civil Code will be applied subject to these procedures). For example, it is not only bearer securities that cannot be recovered from the possession of *bona fide* purchasers (as under the general Civil Code rules on restitution), but also order securities and registered securities that evidence a monetary claim. The authors of the Amendments have explained this by noting that the rights of owners of such securities can be effectively protected by receiving damages. The Amendments also provide that certificated securities can be recovered in any case from a person who has fraudulently or otherwise illegally contributed to the loss of the security by its lawful holder, or who was aware or ought to have been aware that other persons had rights to the security.

The Amendments introduce the concept of dematerialised securities (i.e. certificated securities that have been transferred to a custodian and thus are not traded in tangible form). This serves to clarify the nature of

certificated securities with mandatory centralised custody<sup>1</sup>, the legal nature of which had not been addressed by the existing general provisions of the Civil Code on securities.

Certain provisions on uncertificated securities apply to dematerialised securities. In particular, the transfer of rights to dematerialised securities and their recovery from unlawful possession (including from a *bona fide* purchaser) are subject to the provisions on uncertificated securities.

### **Uncertificated securities**

The current rules on mass-issued securities set out in the securities legislation are to a large extent reproduced in a new section of the Civil Code that deals with uncertificated securities.

#### ***Recording rights to uncertificated securities***

The Amendments provide that rights to uncertificated securities (such as shares of a Russian joint stock company) may be recorded only by: (a) an independent registrar acting on the instructions of the issuer, or (b) a custodian acting under a contract with the owner of securities.

According to the transitional provisions, all issuers that now maintain registers of uncertificated securities (including registers of shareholders) will have to transfer them to an independent registrar within one year after the Amendments

come into force<sup>2</sup>. This new development is unlikely to lead to changes in maintenance of the register or dealing in uncertificated securities, as even under the current legislation both issuers and registrars keep registers according to the same rules established by the securities market regulator.

#### ***Transfer of ownership of uncertificated securities***

As presently, the transfer of rights to uncertificated securities will be carried out by debiting securities from the seller's account and crediting them to buyer's account. Under the general rule, as before it will be an order from the seller that constitutes the grounds for making an entry in the register. The Amendments also set out other grounds and conditions on which securities may be debited or credited. Among these, it is now possible to debit securities from the account of a person who is transferring them, without an order from the transferor, if this is provided for by law or contained in the contract between the owner of the securities and the company that records the rights to uncertificated securities (e.g., a custodian).

The Amendments introduce clear rules for scenarios where a seller fails

<sup>1</sup> For example, exchange-traded bonds, government and municipal bonds, mortgage certificates and Russian corporate bonds, which have traditionally been issued in the form of certificated bearer securities with mandatory centralised custody.

<sup>2</sup> It will be unlisted Russian open joint stock companies with 50 or fewer shareholders that will be affected by this change in regulation. For companies that have more than 50 shareholders and public companies (i.e. those that are subject to the disclosure requirements under Art. 30 of the Securities Market Law, irrespective of the number of shareholders) it is already the case that the shareholders' register can only be kept by an independent registrar.

to perform an operation in the register in breach of the contract with the buyer. In such cases the buyer can sue to have an entry made in the register transferring to the buyer the rights to the securities on the terms set out in the contract of sale. Provisions have also been added on the priority of claims filed in court where there are concurrent claims.

#### **Protection of lawful holders of uncertificated securities where the latter are unlawfully debited from their accounts**

The Amendments establish the general rule that a person from whose account securities have been unlawfully debited has an unconditional right to recover the same quantity of securities from the person to whose account such securities were credited. The Amendments specially regulate cases where unlawfully debited securities are converted into other securities, thus removing a legal loophole that has been used by parties in bad faith to hinder the recovery of unlawfully debited securities by lawful holders. According to the Amendments, where securities whose restitution is being sought have already been converted into other securities, the person who was the lawful holder at the time they were unlawfully debited may demand and obtain those securities into which the securities unlawfully debited from his account were converted.

It is also provided that if securities similar to those that have been unlawfully debited can be acquired through an exchange, then the holder may at his discretion demand that those responsible for causing the loss either purchase such securities at their own expense or compensate the holder for the cost of acquiring the securities.

#### **Protection of bona fide purchasers**

In order to protect *bona fide* purchasers on capital markets, the Amendments introduce a provision prohibiting the recovery of debt securities and any securities acquired through an exchange from *bona fide* purchasers. The legislation is quite broadly worded in this respect, whether intentionally or not, and does not limit to anonymous non-addressed trades the mode of exchange trading under which bona fide purchasers are protected.

At the same time, a rule is introduced stipulating that where securities have been obtained free of charge from a person who was not entitled to alienate them, then the lawful holder may recover them in any case.

#### **Legal effects of recovery of uncertificated securities**

The Amendments expressly provide that in certain circumstances a person who has been unlawfully deprived of securities may, after regaining control over those securities, challenge any corporate resolutions that were adopted and at which the unlawful holder voted<sup>3</sup>.

The limitation period for a challenge on these grounds is set at three months following the date when the lawful owner of the securities became aware or ought to have become aware of the unlawful debiting of the

securities from his account, but in any event no later than one year after the relevant corporate resolution was adopted.

The courts may take into account any adverse impact on the interests of creditors or other interested parties and uphold the corporate resolution subject to challenge.

#### **Effects of loss of records confirming rights to uncertificated securities**

General rules are introduced for cases when a register of securities is lost, including the obligation on the part of the registrar to announce the loss of the register in the mass media and the procedure for notifying third parties that the information in the register has been restored. Rights to securities that were recorded in a lost register are to be restored through the courts.

### **Other Amendments**

#### **Integrated set of immovable property**

A new concept of an "integrated immovable property complex" (*единый недвижимый комплекс*) is introduced in the Civil Code, defined as a set of immovable property having the same designated use and treated as a single item of real property. The Amendments stipulate the following criteria, already broadly used in practice, for determining whether items of immovable property that have the same designated use constitute an integrated immovable property complex:

- an indivisible physical or technical connection between the items of immovable property (by this criterion linear facilities such as pipelines, communications lines, power lines, utilities

<sup>3</sup> So far this issue has not been regulated by law and, despite the Resolution of the Supreme Arbitrazh Court dated 5 September 2006 No. 4375/06 in which the court acknowledged the right of a shareholder who has restituted stolen shares to challenge corporate resolutions adopted in his absence, court practice on this issue has still been contradictory.

networks and railways, for example, can be treated as integrated immovable property);

- all of the items of immovable property are located on a single land plot.

In order for an integrated immovable property complex to be recognised as such under Russian civil law, title to all of the individual immovable property assets comprised in it must be registered in the Unified State Register of Immovable Property.

#### **Ownership of benefit, output and proceeds from use of an asset**

The Amendments change the general rule on the ownership of the benefit, output and proceeds from use of an asset. The current version of the Civil Code provides that all benefit from use of an asset belongs to the person legally entitled to use it. According to the Amendments, as a general rule any benefit resulting from the use of an asset will belong to the owner rather than the user (irrespective of who is actually using it).

The general rule will be applicable only in situations where another outcome is not provided for by law, other legal acts or contract, and also in situations where it is unclear from the substance of the relations to whom the benefit, output and proceeds should belong.

We are of the view that this new rule will not affect lease agreements or hire-purchase agreements, as they will continue to fall under the existing rule that the benefit, output and proceeds from the use of leased property belong to the lessee.

#### **Entry into force and transitional provisions**

The Amendments will come into force on 1 October 2013. All issuers that now autonomously maintain registers of uncertificated securities will have to transfer them to an independent registrar within one year after the Amendments take effect.

The Amendments close some significant loopholes in the regulation of civil law rights, although at this point it is uncertain how they will be applied in practice. Guidance could come from clarifications of the Supreme Arbitrazh Court of the RF, but for the time being it remains unclear whether and when they might be issued. Furthermore, some of the new provisions introduced by the Amendments should be viewed in conjunction with the proposed amendments to the chapter of the Civil Code regulating rights *in rem*. However, the final version of those amendments has yet to be prepared.

## Authors



**Tamer Amara**  
Partner

T: +7 495 725 6449  
E: tamer.amara  
@cliffordchance.com



**Alexander Anichkin**  
Partner

T: +7 495 258 5089  
E: alexander.anichkin  
@cliffordchance.com



**Marina Kizenkova**  
Associate

+7 495 725 6401  
E: marina.kizenkova  
@cliffordchance.com



**Ella Omelchenko**  
Counsel

T: +7 495 258 5054  
E: ella.omelchenko  
@cliffordchance.com



**Yulia Prudnikova**  
Associate

T: +7 495 660 8022  
E: yulia.prudnikova  
@cliffordchance.com



**Evgeny Soloviev**  
Counsel

+7 495 725 6420  
E: evgeny.soloviev  
@cliffordchance.com

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