


Real Estate Finance

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REAL ESTATE FINANCE IN RUSSIA

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INTRODUCTION

28.1 During the last decade, Russia has had great success at attracting investment into its domestic real estate market. It is estimated that in excess of US \$11 billion has been invested in the Russian real estate sector from 2006 through to the end of H1, 2008. Despite the global credit crisis witnessed in 2008 and continuing at the time of writing, investments into Russian real estate continue to grow with investments totalling around US \$4.5 billion in H1, 2008, which represents a 246% increase compared to H1, 2007¹. However, the credit crisis has also impacted real estate financing in Russia (as it has done elsewhere across the globe) with lenders reducing their exposure to the real estate sector. As a result, it has become more difficult and expensive to attract real estate financing and the market participants have had to be more creative in raising required debt and funds. In addition, the credit crisis has facilitated the process of consolidation of real estate market players. Weak companies have been forced to sell either their equity stakes or their real estate holdings. Despite this development, some real estate companies are still managing to raise money by stock issuances², and foreign investments real estate funds remain active in the Russian market³.

¹ Profitable Russia, *Vedomosti* newspaper, No 132 of 18 July 2008.

² As an illustration, Open Investments sold circa US \$500 million shares in June 2008, though most of the shares were reportedly sold amongst its existing shareholders.

³ German fund KanAm Grund purchased from Otkrytie-Real Estate the office part of the unfinished Paveletskaya complex for US \$900 million in March 2008. British fund RP Capital Group purchased the Silver City business centre for US \$350 million in April 2008.

28.2 This Chapter will consider the typical issues and challenges connected with the financing and development of real estate in Russia, before considering real estate financing structures and investment funds active in the real estate lending and capital markets.

RUSSIAN REAL ESTATE MARKET

28.3 Real estate funding in Russia is usually split into stages. The most difficult part of a real estate financing is to attract initial funding for a project to buy a land plot, develop project documentation and arrange for the connection of utilities lines. After obtaining a permit for construction, it is much easier to attract money from potential investors. Banks typically provide loans of up to 70% of the cost of a project. The rest is usually provided by way of equity (or loans from companies affiliated with the developer) or by sales of stakes in projects or holding companies.

Real estate title

28.4 Since 1998, rights to real estate in Russia have been subject to registration in the Unified State Register of Rights to Immovable Property and Transactions Therewith (the 'Register'). The Register is maintained by a state authority – the RF Federal Registration Service (the 'Registration Service'). Following the sale of real estate, title passes to the purchaser upon (i) the conclusion of a sale agreement; (ii) the signing of the conveyance deed by the seller and the purchaser; and (iii) registration of the title conveyance with the Register. Under Russian law, title conveyance must be registered within one month from the day of filing documents with the Registration Service although registration, in certain cases, may be postponed for up to three additional months.

28.5 Following the conclusion of the sale agreement and acquisition of the real estate, a buyer is faced with several risks. Such risks include the risk that the seller may refuse to proceed with the conveyance procedure (eg signing the conveyance deed and/or forwarding the application for title registration) or that the seller may make a sale agreement with another party, who takes priority if it succeeds in filing the application for title registration with the Register prior to the buyer. Thus, there is an 'uncertain' period from the conclusion of the relevant sale agreement up to filing the application for title registration.

Comfort to a lender

28.6 When acquiring real estate, the core issue for a lender is whether evidence can be provided that the owner has title to the property. At first, the Register provides any person, upon application, information identifying the real estate in an extract. Such Register extract will contain information about all encumbrances on the real estate (including any mortgages) and a lender can generally rely on such extract.

28.7 Furthermore, although Russian law does not provide for mandatory state registration of ongoing or pending real estate litigation, such information may be submitted to the Registration Service by any related party and registered in the Register. However, whilst state registration is the only evidence of the existence of a registered right, it does not itself constitute title to immovable property and may be challenged in court. Any successful challenge will result in adverse consequences to the borrower's title to such asset. Consequently, it is common to instruct lawyers to conduct legal due diligence to check the title in addition to relying on an extract from the Register.

GENERAL REAL ESTATE LENDING ISSUES

Loan form

28.8 There is no standard form of a real estate loan document in use in Russia. In practice, even if Russian law governs the transaction, the parties

frequently use loan documents based on the standard form loan documentation developed by the LMA¹ or London law firms. Whilst the provisions of an English law governed loan agreement usually remain unchanged, there is the risk that such provisions will not under Russian law operate in the same way.

¹ See further Chapter 8.

Language

28.9 There are no restrictions as to the language of a loan agreement. State authorities (eg the Registration Service) may require the mortgage to be in Russian and as a result the mortgage and the loan agreement must be prepared as separate documents.

Interest rate

28.10 There is no legal limitation as to the maximum amount of interest that can be charged or the ability to compound interest. Parties are thus allowed to include provisions on default interest in the loan agreement. However, according to judicial practice, the court may reduce the amount of default interest if the relevant amount does not adequately reflect the consequences of the underlying breach.

Governing law

28.11 Russian companies may choose a foreign law as the governing law of their contracts, subject to the involvement of a foreign element, including, circumstances where a party to the contract is a foreign entity or person. English law is very popular in Russia, especially in the sphere of international real estate finance. For example, most syndicated loans made in Russia are governed by English law.

28.12 Russian courts can, however, apply Russian law if the courts are unable to interpret or reject evidence of such foreign law. Russian law also permits any dispute, which may arise in connection with contracts involving a foreign element, to be submitted to the jurisdiction of foreign courts. Russian courts may recognise and enforce an arbitral award granted by a foreign jurisdiction, without an examination of the merits of the case, providing such an award is not contrary to the public policy of the Russian Federation.

Ability to lend

28.13 There are no restrictions as to the type of entity (including a non-bank securitisation vehicle) that can own a mortgage loan. Historically, Russian courts had held that a loan initially granted by a Russian bank could not be

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assigned by such bank to a non-banking institution. However, recently the courts have taken the view that Russian banks may assign claims under bank loans to non-banking institutions.

28.14 In addition, Russian law provides that a mortgage loan can be structured both as a certificated right and as a non-certificated right depending on the parties' choice. If a mortgage loan is embodied in a negotiable certificate ('*zakladnaya*'), there are no restrictions as to the type of entity that can own such a certificate.

Data protection

28.15 As a general rule, a Russian bank is not allowed to disclose information about a client to third parties without that client's prior consent. This limitation is mandatory and may be overridden only with the client's consent to disclose such information. A person who unlawfully discloses information protected by law (such as loan information) will be directly liable for such unlawful disclosure. Further, the owner of the information and the party that uses and obtains information on behalf of the owner may be liable for unlawful disclosure.

28.16 There is no general rule on confidentiality of lease information (except for personal data on individuals). However, confidentiality of such information may be established by a lease contract. In such a case, the disclosure of such information, without the prior consent of a party, will constitute a breach of contract and the aggrieved party will be entitled to claim damages.

Taxation

28.17 There are no taxes, stamp duties, or mandatory notarisation for the creation of a loan. Further, there is no prohibitively costly stamp duty for the creation of a mortgage. Under Russian law, loans are transferred by means of assignment. Taxation of the assignment of claims is regulated by Article 155 of the Russian Tax Code which provides for VAT, in case of the assignment of claims arising from contracts which are subject to VAT, at a rate of 18%, at the time of writing. However, there are no express provisions as to whether assignment of claims that arise from contracts for operations not subject to VAT (banking loans, general monetary loans and/or related mortgages) are subject to VAT and the current practice of Russian tax authorities and courts is that the transfer of loans and mortgages is not subject to VAT. The same restrictions also apply to the transfer of a loan/mortgage to a non-bank securitisation vehicle.

28.18 Interest payments made to a foreign lender, having no permanent establishment in Russia from a source within the Russian Federation, are subject to withholding tax. However, the lender may be exempt from Russian withholding tax pursuant to a double taxation treaty. There are more than 70

such treaties in force with Russia, including treaties with the UK, the US, Canada, Luxembourg, Cyprus, Ireland, Germany, the Netherlands and Switzerland, amongst others.

REAL ESTATE SECURITY

Security over real estate

28.19 Real estate lenders in Russia are generally able to obtain a mortgage by way of a security interest over real property. The owner (or the debtor) will retain possession of the real property and the mortgagee will receive the rights to the mortgaged property, pursuant to a written mortgage deed. Such mortgage is registered with the Register, affording priority to the mortgagee from the date of registration. It is also possible to take an assignment of rights regarding leasehold interests in a real property. In practice, security in respect of the real estate itself (with respect to the leasehold interests) is, if the real property generates income (such as a tenanted office building), limited to security over the receivables (each by way of assignment).

Ranking of mortgages

28.20 To secure the priority of the mortgage, it is crucial to register the mortgage as the main risk in establishing priority to the real estate is that the property may have an existing mortgage created over it. Creation of a mortgage is completed when the entry in the Register is processed. Under Russian law, a subsequent mortgage may be created if it is not prohibited by prior mortgage agreements, or if the mortgagee under the prior mortgage gives consent. If consent for a subsequent mortgage is given, the claim of the subsequent mortgagee shall be satisfied following the satisfaction of the claims of the prior mortgage.

28.21 Whilst Russian law permits the registration of the mortgage prior to funding, the mortgage comes into force upon funding. As a result, the risks of intervening charges between funding and registration of the mortgage are typically dealt with by the lender not funding prior to the mortgage being registered. Consequently, from the day of mortgage registration to the date of funding, information concerning the mortgage registration is made publicly available and the mortgage takes effect against third parties.

28.22 Unless an insolvency procedure is commenced against the borrower, no charge/lien may take priority over a first mortgage. However, if there are several judicial awards against the borrower and the borrower has no assets other than the mortgaged/pledged property, prior to the satisfaction of a mortgagee claim, compensation in respect of such awards may be deducted from the proceeds of a public sale of the property for harm inflicted to life,

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health, or moral well-being of individuals, employment obligations, taxes and pension obligations, all of which are statutorily ranked ahead of secured claims.

Taking security

28.23 In Russian legislation, the term 'pledge' ('*zalog*') is used to describe encumbrances of movable property and rights, whereas the term 'mortgage' is used for describing encumbrances of immovable property.

Mortgage

28.24 Land and other real estate is secured by means of a mortgage that is deemed completed when the entry in the Register is processed. Similar to registration of a title transfer, a mortgage should, as stated, be registered within one month from the date of creation.

Leases and rents

28.25 Pursuant to the Mortgage Law¹, mortgages and pledges of a tenant's rights, arising from a real estate lease agreement must be registered in the Register. However, only pledges of tenant's rights that arise from lease agreements in excess of one year must be registered. The Mortgage Law does not regulate pledges for rent receivables, which are created by a simple written pledge agreement.

¹ The Federal Law of the Russian Federation No. 102-FZ on Mortgage (Pledge of Immovable Property) dated 16 July 1998 (as amended).

Bank accounts

28.26 Russian courts do not recognise an account pledge on money in a bank account.

Shares of a company

28.27 Two forms of companies are used in Russia to hold real estate: a joint stock company and a limited liability company. Due to the legal nature of ownership of these companies, different legal regimes apply to each.

28.28 Shares in a joint stock company, may be pledged and perfected by registration in the register of shareholders of the company whose shares are pledged or by a special person acting in the capacity of a registrar. The latter must be licensed and supervised by state authorities.

28.29 Shares in a limited liability company also may be pledged and perfected by the pledge's approval by the limited liability company itself. Such approval shall be confirmed at a meeting of shareholders, where a simple majority of votes is cast in favour of such an approval, unless more votes are required under the charter. Russian limited liability companies do not have shareholders' registers, so there is no registration system for such pledges.

Security over insurance proceeds

28.30 The assignment of rights to insurance proceeds in favour of a third party is prohibited. Therefore, Russian law prohibits a pledge of such rights. A pledge of such rights is also prohibited because levy of execution on a pledged property requires its public sale, resulting in an assignment. However, an assignment (and consequently a pledge of the right to insurance proceeds) following the occurrence of an insured risk is not prohibited.

Security over an 'enterprise'

28.31 The mortgage of an 'enterprise' (which is considered by legislation to be real estate), is possible when the amount of the loan secured by such a mortgage is less than 50% of the enterprise value and its term does not exceed one year. The granting of a mortgage is deemed completed when the entry in the Register is processed.

28.32 A court may re-characterise a pledge of the whole or part of the assets of an enterprise as a mortgage. If this happens, the pledge will be subject to restrictions provided for mortgages of an enterprise (such as a required book-entry approach to perfect the mortgage).

Mortgage certificate ('zakladnaya')

28.33 Under Russian law, a mortgage may be incorporated in the mortgage certificate ('zakladnaya'), which is a security conferring rights under a certain mortgage loan and a mortgage secured by the real estate.

28.34 Creation of mortgage certificates can mitigate different risks inherent to the 'true sale' of mortgages such as:

- in order to transfer loans and mortgage, the holder of a mortgage certificate must make an endorsement and deliver the mortgage certificate to the purchaser. This gives the purchaser comfort that the seller has the title to the mortgage certificate;
- the rights embodied in the mortgage certificates may not be prohibited from transfer. Thus, if an assignment is prohibited by the mortgage agreement (non-assignment clause), the mortgage certificate should still allow the transfer of rights (eg for the purpose of securitisation); and

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- there is no restriction as to the type of entity that can own a mortgage certificate.

Transfer of security

28.35 Under Russian law there is no mandatory requirement to notarise transfer/security documents and whilst the transfer of a mortgage requires state registration, the transfer of a mortgage certificate does not require registration.

28.36 It is common practice to use a security trustee in order to mitigate difficulties with the transfer of security in international real estate financial transactions. However, under Russian law it is assumed that the pledgee, not the security trustee, is a creditor and that the security trustee merely holds the security on behalf of the creditors. Thus, Russian courts may refuse to enforce such security on behalf of a security trustee.

28.37 A question arises as to whether a parallel debt can be utilised in order to implement a security agent. A parallel debt structure is not well established under Russian law. Parallel debt structures in contracts with Russian parties, governed by English law, have never been tested in Russian courts and run the risk of not being enforced by the Russian courts.

Enforcement of security

28.38 Under Russian law, claims of the lender are satisfied from the proceeds of the sale of mortgaged property. In the case of mortgage enforcement, the mortgaged property is sold by means of a public sale, conducted by an organisation specialising in such sales. If a public sale is not effected, eg because of an absence of bids, the lender has the right to acquire the mortgaged property by agreement with the borrower and to set it off against the purchase price of not less than 90% of its claim secured by the mortgage.

28.39 Enforcement of a real estate pledge can be levied without application to a court by a notarially certified agreement between the pledgee and the pledgor entered into after occurrence of the event giving rise to the pledge's foreclosure. Enforcement of a pledge may be refused if a default is considered by the court to be 'extremely insignificant' and, as a result, the creditor's claim is 'obviously incomparable with the value of the pledged assets'. Enforcement of real estate security usually takes about four months before the court decision comes into force. Public sale of the mortgaged property is usually effected within two months of the delivery of an enforcement order. However both judicial and execution proceedings may be delayed based on a set of grounds established by law (eg the need for additional evidence).

28.40 Enforcement under Russian law may involve certain moratoriums. As discussed above, the enforcement of a pledge under Russian law requires the public sale of the pledged/mortgaged property. A court may delay such public sale for a period of up to one year upon a pledgor's/mortgagor's application. However, this delay does not exempt the borrower from compensation of damages connected with such delay. Further, in practice the courts rarely are the cause the delay. Exceptions are usually made for subjects of the Russian Federation and municipalities when a significant sum of debt is owed.

Tenant leases

Term and adjustment

28.41 As a general rule, parties to a lease may agree upon the term of a lease agreement (both commercial and residential) as they see fit. The law may set a maximum term for leases of certain types of real estate or for certain types of lease contracts, but this largely concerns development plots and does not apply to commercial real estate. Leases for commercial real estate are generally concluded for a term of five to ten years. There are no statutory limits on rent increases and it is common practice to adjust the rent with reference to certain indicators (eg the inflation index).

Service charges

28.42 Under Russian law, the tenant usually undertakes to pay utilities and service charges. The tenant may not be obliged to pay rental taxes instead of the lessor, but these sums may be added to the rent. Depending on the contractual position, the tenant may also undertake to pay insurance premiums.

28.43 According to the Russian Civil Code, a tenant is obliged (unless the lease agreement otherwise provides) to make ordinary repairs at its own expense and provide for maintenance of the property. Further, a lessor is generally (unless otherwise provided for by law or the lease agreement) obliged to make structural repairs of the leased property at its own expense.

Alienation

28.44 Subject to the lessor's consent, the tenant is entitled to sublease the property pursuant to the terms of the principal lease agreement and to assign its rights and obligations under the lease agreement to other parties. Typically, the lessor's consent is set out in the lease agreement.

Statutory rights of tenants

28.45 Russian law provides the following statutory rights for tenants:

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- (i) right to re-negotiate a lease with a current tenant. Re-negotiation of a lease is regulated by the general provisions of the Russian Civil Code which, as a general rule, allows the re-negotiation of a contract with the agreement of the parties. The parties are obliged to re-negotiate the contract: (i) at the request of a party; (ii) if such right is stipulated in the contract; (iii) if there is a material breach of the contract; or (iv) if there is material change in circumstances from which the parties proceeded when concluding the contract;
- (ii) right to require the borrower/lender to grant a lease to an existing tenant. Unless otherwise determined by law or the lease agreement, a tenant who has complied with its obligations shall have, upon the expiration of the contract term, a pre-emptive right to enter into a lease contract for a new period; and
- (iii) right to terminate a lease upon default. In the case of a commercial lease, prior to filing a claim with the court to terminate the lease, the lessor must deliver written notification to the tenant, demanding that all obligations be complied with within a reasonable period.

28.46 In the case of a residential lease, the court may grant the tenant a period of up to one year to remedy the violations that gave rise to the termination. If the tenant fails to remedy such violations within the period granted, on the application of the lessor, the court will generally terminate the lease contract. However, on the request of the tenant the court may delay enforcement of its decision for a further period not exceeding one year.

Frustration

28.47 Russian law includes force majeure provisions. An obligation is terminated if it is impossible to execute the terms of the contract, based on the occurrence of an event for which neither party is liable. According to the Russian Civil Code, if the property may no longer be occupied and the tenant is not liable for it, the lease can be terminated on the demand by the tenant. As a general rule, whether an event constitutes force majeure, depends on the circumstances of its occurrence. However, Russian courts are reluctant to apply force majeure rules as a basis for a contract's termination.

Termination of lease

28.48 As a matter of Russian law, there are two types of contract termination, 'termination' and 'the refusal to perform'. Termination may be executed by the court on the demand of a party to the contract. Refusal to perform may be executed by a mere notification of a party. The right to declare a refusal to perform must be clearly stipulated in the contract. Termination is executed by means of judicial decision. But prior to filing a claim with the court, the lessor must deliver written notification to the tenant, demanding that the latter perform his obligations within a reasonable term. The general grounds for a

termination of a contract are material breach and material change of circumstances from those that existed at the execution of the contract. Additionally, a court may terminate a commercial lease contract on the lessor's demand where the tenant:

- (1) uses the property in breach of the terms and conditions of the agreement;
- (2) substantially damages the leased property;
- (3) fails to make a rental payment more than two times in succession upon the expiry of the payment date fixed by the agreement;
- (4) fails to carry out structural repairs; or
- (5) where other breaches identified by the lease contract occur.

It normally takes up to six months to terminate a commercial lease in court.

28.49 Upon the termination of a lease, the tenant must return the leased property within the period specified in the lease contract. If the tenant refuses to return the property to the lessor, the latter is entitled to enforce the eviction.

28.50 The grounds for termination of residential leases are limited as compared to those for terminating commercial leases. Thus, 'refusal to perform' is not permitted for residential leases. Consequently, the only way to terminate a residential lease is through the court. In addition to general grounds for the termination of contracts, the court may terminate a residential lease contract on the lessor's demand where the tenant, either (i) delays the payment of rent for a period of six months (unless the contract stipulates a longer period) and in the case of a short-term rental, where payment has not been made for more than two payment periods upon the expiry of the term of payment fixed by the contract; or (ii) damages the leased property.

28.51 However, the court may grant a period of up to one year to remedy violations that were the grounds for termination. If the tenant fails to remedy such violations within the period granted, the court, on the demand of the lessor, may terminate the lease contract. However, at the request of the tenant, the court can postpone enforcement of the decision for a period not exceeding one year. Thus, legal proceedings for terminating residential leases in court and evicting the tenant may last up to three years.

Purchase of property by tenant

28.52 The Russian Civil Code provides that the statute or the lease contract may stipulate that the title to leased property is to be transferred to the tenant upon the expiry of the lease period or before its expiry, provided that the tenant has paid the price specified by the contract. The law permits the parties of a lease contract to establish an appropriate purchase price. Any new owner will be bound by the terms of the tenant's right to purchase the leased property. However, current Russian legislation has not established any such rights for tenants.

Impact of insolvency on leases

Insolvency of landlord

28.53 Under Russian law, the sale of property during the course of insolvency proceedings does not affect the rights of a tenant under a lease agreement. Nevertheless, there are some exceptions to this rule. For instance, the mortgaged property may be leased for a period not longer than the term secured by the mortgage. Lease agreements concluded prior to the establishment of a mortgage remain in force despite the enforcement of the mortgage. Lease agreements concluded after the establishment of a mortgage are terminated upon the enforcement of the mortgage, unless the mortgagee gave consent to the lease.

Insolvency of tenant

28.54 In relevant cases, the court may terminate a commercial lease contract on the lessor's demand where the tenant fails to make a rental payment more than two times in succession when due. In residential leases, the court may terminate the contract on the lessor's demand where the tenant fails to make a payment for six months, unless the contract fixes a longer period and in case of short-term renting, when payment has not been made more than two times when due. Pursuant to the Russian Civil Code, the liquidation (both voluntary and as a result of bankruptcy) of a legal entity, terminates its rights obligations. Any payments owed under the lease will be repaid in accordance with the creditors' priorities and the bankrupt tenant must return the property to the lessor within the winding-up period.

Clawback

28.55 Under Russian insolvency law, an insolvency administrator may challenge the validity of the transaction concluded or entered into by the debtor on the following grounds:

- preferential treatment: a transaction entered into by the debtor after the initiation of insolvency proceedings or six months prior to the filing of a relevant insolvency petition, leads to the preferential treatment of a purchaser or other existing creditors of the seller in the latter's insolvency;
- undervalue (applies only to banks and other credit organisations): a transaction entered into within three years prior to the appointment of a temporary Central Bank administration of the debtor, on conditions materially worse than those of analogous transactions concluded in similar circumstances; and
- interested party transactions: the purchaser is deemed an interested party for the purposes of Russian insolvency law (ie parent company or subsidiary, common members of the board of directors, chief executive administrators, chief accountants, etc of the debtor) and the transaction results in, or may result in, damages to the debtor or his creditors.

28.56 In addition, the insolvency administrator may challenge the validity of a transaction on general grounds of invalidity. That is, the sale may be deemed invalid under the general provisions of the Russian Civil Code (eg transactions that are ultra vires, sham transactions, etc). Russian insolvency law does not generally provide for the consolidation of the assets of solvent entities with the assets of an insolvent company. However, if the insolvency is caused by the actions of the insolvent entity's shareholders or other entities having the power to give mandatory instructions to the insolvent entity (eg by virtue of a controlling stake, agreement or otherwise), such controlling entities will incur subsidiary (secondary) liability with the insolvent entity for the latter's debts.

REAL ESTATE – SECURITISATION

28.57 This section of the Chapter will discuss the major aspects of Russian real estate securitisation legislation¹, as well as consider the general issues of Russian real estate securitisation in both domestic and international transactions. Domestic and international securitisations of Russian real estate have, at the time of writing, consisted of residential property only. Nevertheless, it is expected that commercial real estate securitisation will also take place in the future. Accordingly, this section of the Chapter shall consider both residential and commercial real estate securitisations.

¹ Federal Law No. 152-FZ of 11 November 2003 'On Mortgage-Backed Securities'.

Overview

28.58 There have been three domestic and over ten international securitisations related to Russian real estate since 2005. Whilst the low number of domestic deals is explained by the fact that Russian securitisation legislation was only introduced in 2003 and is yet to be tested in many respects, there is an increased understanding by foreign investors of the Russian securitisation legislation. This, together with the introduction of Russian mortgage certificates as a liquid source of collateral, has resulted in Russia becoming an emerging securitisation market.

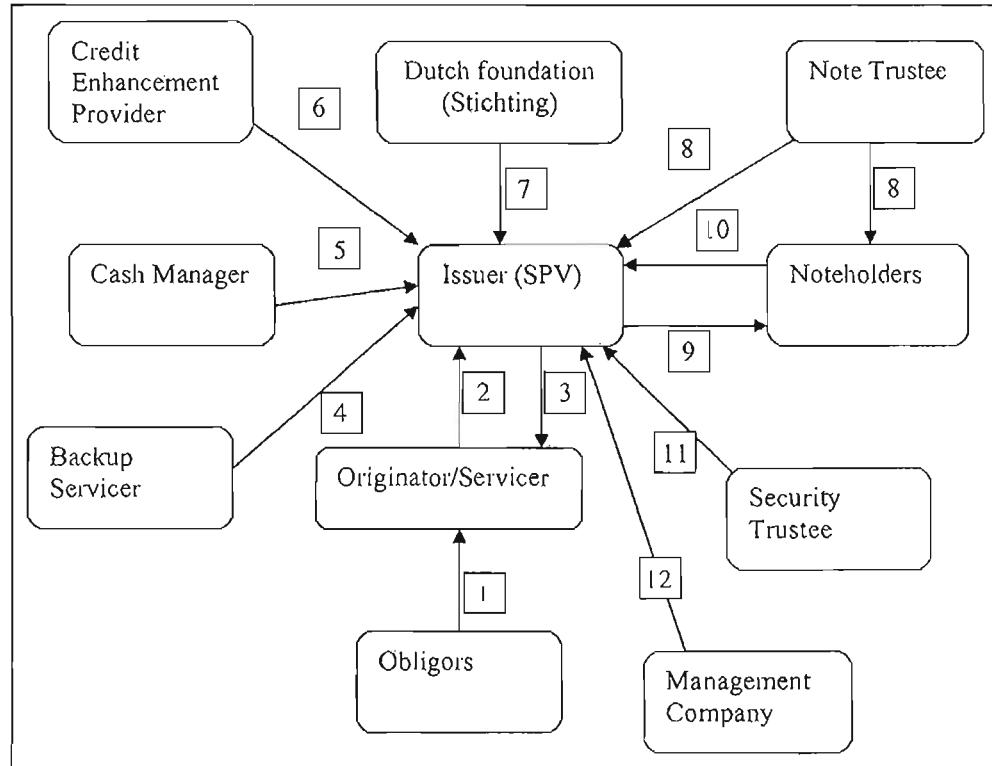
Deal structure

28.59 Russian real estate securitisations (both domestic and international) are similar in structure to the developed European markets¹. An originator sells a pool of mortgage loans (secured by mortgages over real estate) to a special purpose vehicle ('SPV'). The SPV issues mortgage-backed securities to capital market investors, secured by the pool of mortgage loans. The proceeds from the issuance of such securities are used to finance the acquisition of the mortgage portfolio. The originator receives interest and principal payments on the loans and also acts as servicer of loans on behalf of the SPV. The payments due to the holders of the securities are paid from the mortgage portfolio proceeds.

¹ See Chapters 16 and 17 for further discussion on European and US mortgage-backed securitisation.

28.60 Diagrams 1 below and 2 overleaf illustrate international and domestic Russian RMBS transactions, respectively.

Diagram 1: Typical structure of an international RMBS transaction

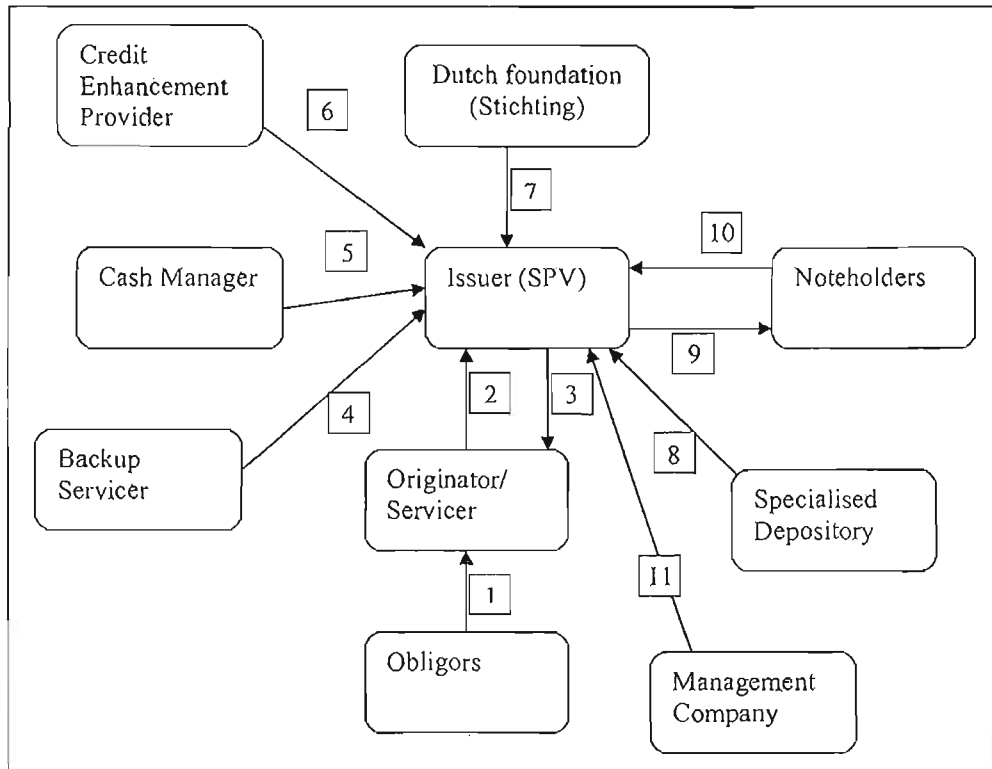


- (1) Proceeds from mortgage loans.
- (2) Sale of mortgage portfolio.
- (3) Proceeds from sale of mortgage portfolio.
- (4) Substitution of servicer in case of default of the original servicer (originator).
- (5) Managing of the SPV's accounts.
- (6) Credit enhancement required to assign target rating to the issued notes (liquidity facility, suretyship, etc).
- (7) A fund non-related to the sponsor of the transaction owns 100% of SPV's shares making it an orphaned company.
- (8) Note trustee acts in the interests of noteholders in the transaction.
- (9) Sale of notes (mortgage-backed securities).
- (10) Proceeds from the sale of notes.
- (11) Security trustee holds mortgage portfolio, SPV's accounts and all the SPV's rights from the transaction documents on behalf of the noteholders.

- (12) A management company to the sponsor of the transaction manages the SPV's activities which reduces the conflict of interests between the sponsor and the noteholders.

28.61

Diagram 2: Typical structure of a Russian RMBS transaction



- (1) Proceeds from mortgage loans.
- (2) Sale of mortgage portfolio in the form of mortgage certificates.
- (3) Proceeds from sale of mortgage portfolio.
- (4) Substitution of servicer in case of default of the original servicer (originator).
- (5) Managing of the SPV's accounts.
- (6) Credit enhancement required to assign target rating to the issued notes (liquidity facility, suretyship, etc).
- (7) A fund non-related to the sponsor of the transaction owns 100% of SPV's shares making it an orphaned company.
- (8) Specialised depository keeps the mortgage portfolio in custody, provides accounting of property included in and supervises payment made at the expense of the mortgage portfolio.
- (9) Sale of notes (mortgage-backed securities).
- (10) Proceeds from the sale of notes.

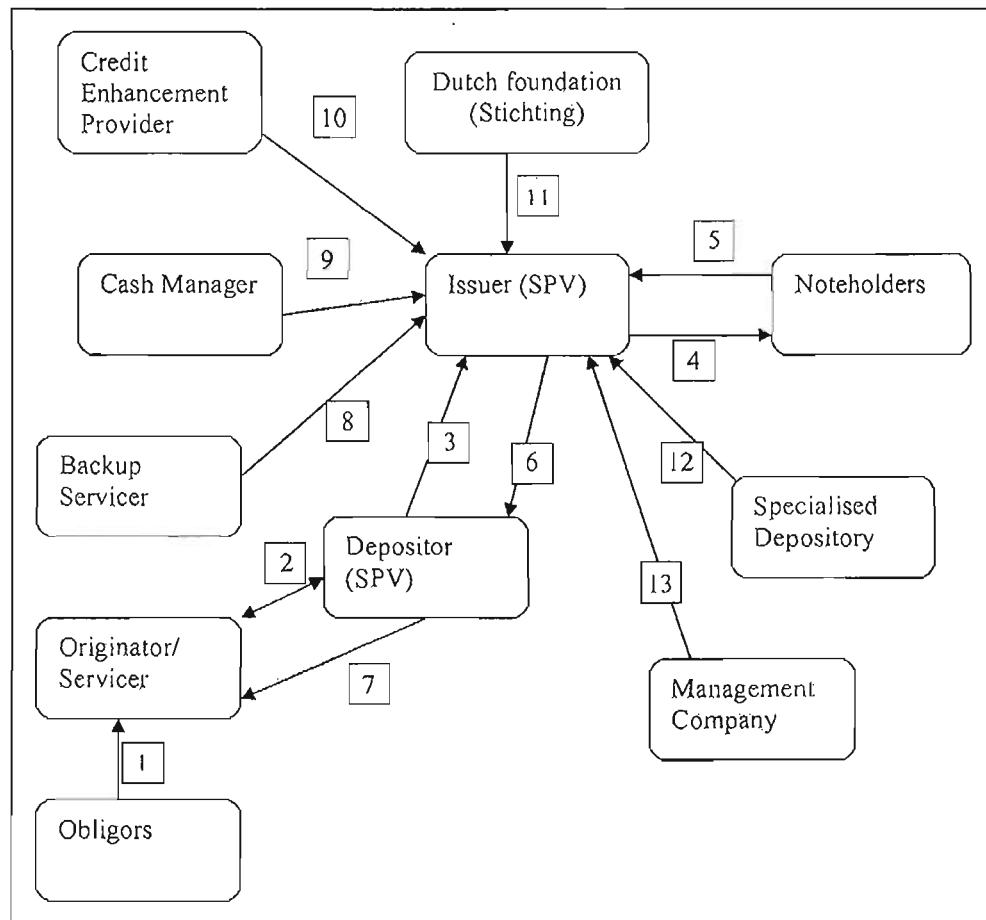
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(11) A management company to the sponsor of the transaction manages the SPV's activities which reduces the conflict of interests between the sponsor and the noteholders.

28.62 Whilst Russian commercial real estate has yet to be securitised, there is a greater variety of cashflow types that can be securitised, including lease payments and land rent. In order to securitise such cashflows, the payments must first be converted into negotiable instruments, namely mortgage certificates, which are eligible for inclusion in a mortgage portfolio. The cashflows are converted into negotiable instruments by the originator entering into a loan agreement (also in the form of a mortgage certificate) with an intermediary SPV depositor. The depositor subsequently sells the mortgage certificates to the SPV issuer for inclusion in the mortgage portfolio. A proposed structure for a Russian CMBS transaction is set out in Diagram 3 below.

28.63

Diagram 3: Proposed structure of a debut Russian CMBS transaction



- (1) Proceeds from commercial mortgage loans, commercial leases and land rent.
- (2) Loan agreement in the form of mortgage certificate with respect to each financed property.
- (3) Sale of mortgage portfolio in the form of mortgage certificates.
- (4) Sale of notes (mortgage-backed securities).
- (5) Proceeds from the sale of notes.
- (6) Payment for the mortgage portfolio (proceeds from the sale of notes).
- (7) Loan funding (proceeds from sale of mortgage portfolio).
- (8) Substitution of servicer in case of default of the original servicer (originator).
- (9) Managing of the SPV's accounts.
- (10) Credit enhancement required to assign target rating to the issued notes (liquidity facility, suretyship, etc).
- (11) A fund non-related to the sponsor of the transaction owns 100% of SPV's shares making it an orphaned company.
- (12) Specialised depository keeps the mortgage portfolio in custody, provides accounting of property included in and supervises payment made at the expense of the mortgage portfolio.
- (13) A management company to the sponsor of the transaction manages the SPV's activities, which reduces the conflict of interests between the sponsor and the noteholders.

Securitisable assets

28.64 The types of Russian real estate income that may be securitised include, amongst others, mortgage loan proceeds, lease payments and land rent. Nearly all securitisations of Russian real estate (both domestic and international) have included portfolios of mortgage certificates, which incorporate the underlying loan agreement and related mortgages of real estate. There have also been a number of domestic transactions which securitise payments for real estate leasing and land rent. The mortgage certificates are of particular importance to the holder as they entitle the holder to seek performance of the related debt claim without further evidential proof and also pledge the real estate in favour of the holder.

Standard loan documentation

28.65 Participants in the Russian residential loan market use standard mortgage certificates similar to the form developed by the Russian state-owned Agency for Housing Mortgage Lending ('AHML'). The standard documentation significantly facilitates the legal analysis of the underlying mortgage loans. Conversely, however, commercial mortgage loans are customised to the needs of particular obligors and are not standardised. Market participants must, therefore, carry out detailed legal analysis of commercial mortgage loans.

Critical legal issues

Assignment

28.66 It is important that the contractual terms of any asset to be securitised allow for assignment, otherwise a true sale of receivables will not be possible. An assignment must be an absolute assignment and not by way of security only. Under Russian law, any agreement that attempts to transfer a contract which prohibits assignment will render such transfer null and void. Therefore contractual instruments with restricted assignment are not eligible for securitisation. The transfer of a mortgage loan (which permits transfer) to an issuer will automatically result in the issuer also being transferred all related rights (such as all security rights) provided that all registration requirements (such as registration on the Register) are complied with.

Notification of obligors

28.67 Whilst not required to perfect a transfer, an issuer will typically notify an obligor that its mortgage loan has been transferred to it. Following receipt of a notice of assignment, the obligor is obliged to make payments directly to the issuer, with the notice also eliminating any future set-off claims the obligor may have against the loan originator. The notification increases cashflow protection from potential bankruptcy of the originator.

Set-off

28.68 Set-off may be restricted in the agreements with obligors, thereby reducing the number of legal challenges for the obligors to refuse to pay and consequently improving stability and protection of cashflow. As mentioned above, any historic set-off rights an obligor may have against an originator will be extinguished upon the issuer notifying the obligor that the mortgage loan has been assigned to it.

Subleases

28.69 Subleases can be restricted or made compliant with the terms and conditions of the real estate leases so as to give added protection to investors. The sublessee eligibility criteria may be specified in the lease agreement making it easier for the noteholders to control the use of the financed real estate through the loan and bond covenants entered into by the originator (owner and lessor of real estate) and the issuing SPV.

Information disclosure

28.70 All banks making residential mortgage loans will collect personal information about the obligors. Such personal information, including full

name, residential address and the financial condition of obligor, is automatically transferred with the mortgage loan. It is important to note that a transferee is not required to be a licensed Russian bank, which means a transferee is not required to comply with Russian banking secrecy legislation.

28.71 In the case of the securitisation of commercial real estate, lenders will also require disclosure of financial information with respect to material obligors. Such disclosure can be achieved through the express agreement of an obligor in the contract to disclose its financial information to the lender and any securitisation noteholders. Such financial information typically will include balance sheet and profit and loss accounts, statement of income, statement of changes in equity, statement of cash flow and notes to financial statements together with an auditor's opinion.

Remedies of creditor

28.72 At the asset level, it is important to ensure that the termination of a contract is available to the lender in the case of a default of the obligor. In a commercial real estate securitisation, the ability to terminate at will assists the creditor (via the servicer) to seize the property from the defaulted obligor and subsequently sell it.

SPV

28.73 As stated, a bankruptcy remote SPV is used to isolate the securitised assets in order to reduce the risk of third party creditors claiming against the securitised assets. Isolating the cashflow separates the credit quality of the mortgage-backed securities from the credit quality of the originator and makes the real estate cashflow the major pricing factor for investors. In Russian real estate securitisations a mortgage agent is used as an SPV. The mortgage agent is a legal entity which has the following features of bankruptcy remoteness: (i) special purpose and special legal capacity; (ii) no employees; and (iii) special company name.

(I) SPECIAL PURPOSE AND SPECIAL LEGAL CAPACITY

28.74 The mortgage agent will have only one purpose, namely the acquisition of a mortgage portfolio and the issuance of mortgage-backed securities secured by that mortgage portfolio. The mortgage agent will be permitted to enter into any agreement (and perform its obligations thereunder) related to the acquisition of the mortgage portfolio and the issuance of the mortgage-backed securities, but other activities are prohibited. This reduces the possibility of having potential claims of third party creditors. The mortgage agent's charter must also describe the types of activities and transactions that it may conduct. This provides important protection for the securitisation noteholders because any transactions entered into by the mortgage agent in violation of its charter (and legislation) will not bind it.

(II) NO EMPLOYEES

28.75 The mortgage agent may not have any employees. This rule eliminates a group of potential creditors that would be senior to the holders of mortgage-backed securities in case of the bankruptcy of the mortgage agent.

(III) SPECIAL COMPANY NAME

28.76 The mortgage agent's company name must include the words 'mortgage agent'. No other legal entity may have such words in its company name. This rule means all third parties are deemed to be aware of the mortgage agent's special legal capacity and consequently eliminates restitution claims of those third parties if a transaction is made contrary to the mortgage agent's special legal capacity and is declared void.

28.77 In addition to the above requirements, Russian legislation contains rules that help make the mortgage agent an orphaned company, ie a company that is not related to the sponsor, originator or servicer. Such rules include the requirements that a separate legal entity must perform the functions of an executive body of the mortgage agent and the accounting of the mortgage agent.

28.78 Appointment of a reputable organisation as an executive body and accountant of the mortgage agent provides additional protection to investors and mitigates conflict of interests between the issuer of securities and the holders of the securities. Furthermore, the shares in the mortgage agent will be transferred to a company that is not related to the transaction participants. Such entity will hold the shares on behalf of the securitisation investors (for example, such vehicle may be created as a special purpose fund or trust). All the abovementioned features have been utilised in domestic and international real estate securitisations.

Debt instrument

Mortgage bond

28.79 In Russian securitisation transactions, the mortgage agent issuer will issue mortgage bonds to investors to refinance its underlying receivables through the capital markets. The mortgage bonds entitle the investors to the right to receive principal and interest.

28.80 As mentioned at paragraph 28.59, the mortgage bond is secured by the underlying mortgage portfolio and the holders of the securities obtain security interests with respect those assets. The holders of the mortgage bond are entitled to accelerate (ie redeem) the mortgage bond in case of an event of default. Events of default are described in the issuance documents and include,

amongst other things, breach of portfolio ratios or other security arrangements, payment defaults of the senior classes and conducting activities not stipulated in the mortgage agent's charter or which are not permitted by law.

Tranching and subordination

28.81 The mortgage agent will issue several classes of bonds with respect to the same mortgage portfolio that are tranching and subordinated. This way, it is possible to have a waterfall of payments by assigning different payment priorities (reflecting the risk appetite of each class of investor) to different issuances of securities. Payments to noteholders are generally made subordinated to payments of the servicer fee, specialised depository fee, stock exchange fee and other payments, which must be specified in the issuance documents. If several issuances of mortgage bonds are made with respect to the same mortgage portfolio, the holders of mezzanine and junior securities will be paid only when the holders of senior securities have been paid in full. It is impossible under current legislation to issue unsecured tranches of mortgage bonds.

Mortgage portfolio

28.82 The mortgage portfolio may only be comprised of mortgage loans (including the related mortgage certificates), monetary funds in the Russian Federation's currency or in a foreign currency, government securities and real estate.

28.83 In order to be eligible for inclusion in a securitisation mortgage portfolio, both residential and commercial mortgage loans must comply with the following mandatory requirements:

- the loan to value must not exceed 70%;
- the mortgage agreement securing the loan must not provide for the possibility of replacement or alienation of the mortgaged property by the mortgagor without the consent of the mortgagee;
- the mortgaged real estate must be insured against the risk of its loss or damage for the benefit of the mortgage creditor for the whole term of the mortgage loan. The insurance must cover no less than the principal debt; and
- the loan must be made in monetary funds.

28.84 Furthermore, the portion of loans secured by partially-constructed real estate must not exceed 10% of the aggregate mortgage portfolio amount.

Management of mortgage portfolio

28.85 Mortgage loans included in the mortgage portfolio may be sold or replaced if they cease to be eligible for inclusion in the portfolio (based on the

above criteria), or the obligor does not make any scheduled payments within three months from the due date for payment under the loan or the obligor delays payments more than three times within a 12-month period. Any substitute mortgage loan together with any cash proceeds from the sale of the non-complying mortgage loan will be added to the mortgage portfolio.

Security

Security interest

28.86 At the asset level, as discussed at the beginning of this Chapter, a mortgage loan is secured by a mortgage of real estate. The Russian law mortgage is a security interest that allows the mortgagee to enforce against the mortgaged property in case of a default of the obligor. The title to mortgaged property (and, in practice, possession) remains with the mortgagor. The mortgage is perfected by state registration in the Register.

28.87 At the bond level, the performance of obligations under the mortgage bonds is secured by a pledge of the mortgage portfolio. The pledge is deemed to be created when the initial holder acquires a mortgage bond. The security interest to the mortgage portfolio is transferred together with the title to the mortgage bond and cannot be transferred separately. The holder of a mortgage bond of one class has equal rights with other holders of mortgage bonds of the same class in relation to the same mortgage portfolio. The pledge of the mortgage portfolio gives the investors a first ranking claim to the portfolio assets in the insolvency proceedings. This claim is senior to claims of the mortgage agent's unsecured creditors.

Enforcing against the mortgage portfolio

28.88 The holders of the mortgage bonds may enforce against the mortgage portfolio in the case of a default of the issuer. The enforcement is carried out on the basis of a court decision. Generally, enforcement of mortgage loans and other assets is conducted by way of public sale. There is a two-month mandatory valuation period starting from the due date for repayment of the mortgage bonds during which the sale of the mortgage portfolio is not allowed. Following the public sale of the mortgage loans, the sale proceeds are distributed according to the transaction's priorities of payment amongst the holders of mortgage bonds.

Sale of mortgage portfolio in case of bankruptcy of an issuer of mortgage bonds

28.89 In the event of a bankruptcy of the mortgage agent, the mortgaged property securing the mortgage bonds is not included in the bankruptcy estate and is ring fenced for the benefit of the holders of the mortgage bonds. The mortgage portfolio will be sold outside of the bankruptcy and the sale

proceeds shall be used to satisfy the claims of the holders of mortgage bonds. From the date of entry into force of a state commercial (*'arbitrazh'*) court's decision on declaring the issuer of mortgage-covered bonds insolvent, the mortgage loan included in the mortgage portfolio may not be substituted.

28.90 Within nine months of the date of the court's decision declaring the issuer insolvent, the insolvency administrator is obliged to sell the property constituting the mortgage portfolio and use the proceeds to settle amounts due to the holders of mortgage bonds, as well as arrange payment of all administrative expenses. The proceeds from sale are first used to pay administrative expenses of the insolvency administrator and then the balance is distributed amongst the holders of the mortgage bonds according to the transaction's priorities of payment.

Specialised depository

28.91 A specialised depository will keep in safe custody the property (mortgage loans, monetary assets, state securities) falling within the mortgage portfolio from the moment the assets are acquired by the mortgage agent. A specialised depository also undertakes accounting of the mortgage portfolio by keeping a register of the mortgage portfolio and will also supervise any disposal of the portfolio property. Thus, the property included in the mortgage portfolio may be sold or substituted only with consent of the specialised depository. The specialised depository is obliged to give the issuer consent to dispose of the mortgage portfolio property and follow the instruction of the issuer, provided that the disposal is in accordance with legislation and the terms of the issuance documents. Otherwise, the depository may not use or dispose of the property constituting the mortgage portfolio or otherwise transact with the mortgage securities.

28.92 The specialised depository is obliged to act in the interests of all of the holders of mortgage bonds and is required to inform them about the occurrence of events of default giving them the right to accelerate the mortgage bonds. The functions of the specialised depository may be performed by a commercial organisation that holds a licence for carrying out specialised depositories of investment funds, unit investment funds and non-government pension funds or that holds a licence for carrying out depository activities on the securities market. A specialised depository cannot be affiliated with the issuer of the mortgage bonds.

Cashflow protection

28.93 There are several legal techniques that are used to protect the cash-flows in real estate securitisations. The most important are:

- waiver of set-off with respect to bank accounts;
- waiver of set-off in mortgage loans;
- rated bank; and

- regular cash sweep of rental income.

28.94 In practice, originators and servicers collect loan proceeds from bank accounts opened in the name of borrowers. These bank accounts are opened specifically for the purpose of collecting rental income to be applied in repayment of the loan. Although this is considered to reduce risk, at the same time, there is a possibility that the bank will conduct separate banking businesses with the borrowers using other accounts. To reduce the risk of set-off and counterclaims from the borrower, the borrower will waive all its rights of set-off and counterclaims in the individual bank account agreements. For the same reasons, the borrower will also waive its right of set-off and counterclaim in the mortgage loans.

28.95 The cash accounts of the SPV are usually opened with a bank that has a credit rating of a particular level required for the transaction. If the credit rating of the bank is downgraded below the specified level, the SPV's cash must be transferred to another bank with the necessary credit rating so as to protect the cash from the potential insolvency of the SPV's account bank. Russian law does not provide for escrow accounts and therefore there will typically be a regular sweep of the servicer's collection account in order to protect the transaction cashflow from a potential insolvency of the servicer.

Proposed changes to Russian securitisation legislation

New legislative initiatives

28.96 Several legislative initiatives directly relating to securitisation in Russia have recently been launched. In April 2008, a number of leading participants of the Russian securitisation market instructed Avakian, Tuktarov & Partners to prepare a draft of a new Russian securitisation law (the 'Draft Law') introducing amendments to various legislative acts. The Draft Law is expected to facilitate the securitisation of further financial assets than are currently capable of being securitised. Its main innovative features are described in paragraphs 28.97–28.103.

Cashflow protection

28.97 An SPV's monetary assets should be capable of being held in an escrow account. The assets held in escrow accounts would not be included in a bankrupt estate in the case of insolvency of a servicer or an originator.

Tranching and subordination

28.98 The Draft Law provides for structuring of different tranches of debt securities with different rights, security ranks and payment priorities. Subordination and payment priorities specified in the issuance documents are binding

on all third parties and will take effect in case of a bankruptcy of the issuer. Subordination at the contractual level allows the sponsor of the transaction and other persons to provide subordinated financing to the SPV.

Flexible debt instrument

28.99 The Draft Law allows incorporation of various customised sets of rights into a bond. It will make it possible to create credit linked notes, interest-only notes, synthetic notes and other debt instruments under Russian law.

OTC credit derivatives enforceable

28.100 The Draft Law grants enforceability to over-the-counter credit derivatives entered into by a Russian SPV in Russian courts.

Wide range of security

28.101 The Draft Law will allow any type of asset to be pledged under a secured bond.

Noteholders' meeting and note representative

28.102 The concepts of the noteholders' meeting and the note representative should be introduced into Russian legislation. Noteholders should be able to make and enforce key decisions with respect to the debt securities they hold. The note representative should be entitled to act on behalf of the noteholders in dealings with the issuer, relating to monitoring bond covenants and security and to declaring the occurrence of an event of default.

Facilitated assignment of receivables and future rights

28.103 Assignment of monetary claims (receivables) should be valid and enforceable even if the assignment of such rights is prohibited in the agreement. This will greatly reduce risk associated with a 'true sale' of such receivables. Assignment of future rights should be expressly permitted, which will facilitate certain types of securitisation (including whole business securitisation) under Russian law.

REAL ESTATE INVESTMENT FUNDS IN RUSSIA

General

28.104 Real estate investment funds ('REIFs') are a prime example of the increasing liquidity of real estate as an asset class. REIFs have become

increasingly popular in Russia since 2001, when the modern Russian legislation on investment funds was introduced.

28.105 The main factors that have contributed to the increasing popularity of REIFs are: improved regulation, taxation privileges, an increased desire to attract investment in construction projects by retail investors, steady price increases in Russian real estate and the poor performance of the stock market at the time of writing. As of the end of June 2008, the RF Federal Service on Financial Markets (the 'FSFM') had registered 307 REIFs (25 of which were at the formation stage and about 95 of which REIFs had been launched since the beginning of 2008). As at the time of writing, investment units in about 83 REIFs were being traded on major Russian stock exchanges.

Sources of regulation

28.106 The main source of regulation of REIFs and their activities is the Federal Law of the Russian Federation No 156-FZ on Investment Funds dated 29 November 2001 (the 'Funds Law'). There has also been a substantial body of secondary legislation enacted by FSFM.

Recent legislative changes

28.107 In late 2007, amendments were introduced to the legislation on REIF regulation¹. These amendments aimed to improve the regulation of REIFs and have, among other things, (i) widened the scope of activities that REIFs can undertake; (ii) introduced the concept of qualified investors; (iii) enabled REIFs to use loan funds; and (iv) clarified certain taxation issues. These amendments will be examined in paragraphs 28.108–28.122. The secondary legislation required to implement these amendments has recently been adopted. Two important FSFM regulations are expected to come into force towards the end of 2008.

¹ The RF Federal Law No. 334-FZ dated 6 December 2007 on the introduction of amendments and changes to the Federal Law 'On Investment Funds' and certain legislative acts of the Russian Federation.

Main specialisations of REIFs

28.108 REIFs usually engage in one of three types of business connected with real estate. Development funds are primarily involved in real estate construction and redevelopment. Rent funds focus on purchasing title to potentially income bearing real estate, with their basic income being generated from commercial leases of such real estate and ancillary income being generated from growing capitalisation of the real estate (as of March 2008, about 30% of REIFs were rent funds¹). Finally, there are also funds specialising in the purchase of real estate property for future resale.

¹ Even though the term 'rent fund' is not statutorily defined, references to rent funds can be found in FSFM secondary legislation.

Investor base

28.109 Russian and foreign individuals and companies can invest into REIFs. Investors in REIFs typically include owners of real estate, construction and development companies and private and institutional investors. As discussed below, an investment in a Russian REIF can have tax benefits for an investor and can also protect assets against hostile takeovers. These benefits often explain the presence of so-called strategic investors in many REIFs, as such investors attempt to take advantage of these benefits.

Closed-end real estate investment funds

28.110 REIFs can be organised as either closed-end or joint stock real estate investment funds, whose assets can include real estate property. This section examines the regulation of closed-end real estate investment funds ('CEREIFs'), which are the most popular form of Russian REIF. The CEREIF is not deemed a legal entity under Russian law. Instead, the CEREIF comprises a collection of assets transferred to the founders for fiduciary management of the CEREIF by a management company holding a special licence issued by FSFM. Under Russian law, the concept of fiduciary management includes some of the features of an English law trust. The management company manages the investments and the assets of the REIF and is paid a fee for providing these services. The REIF also engages a depositary, a registrar, an auditor and an appraiser to provide certain services (more detail on these service providers is provided in paragraph 28.119).

28.111 Investors in the CEREIF own the CEREIF's assets as joint shared property and therefore own a proportion or share of the funds' assets. The management company issues non-documentary securities to investors certifying their right to a share of these assets (investment units). The CEREIF's assets may not be divided or apportioned in any way and so an investor will not own a specific asset of the CEREIF. The main difference between a CEREIF and a joint stock real estate investment fund ('JSREIF') is that a JSREIF is a legal entity (effectively an SPV regulated by both the Funds and JSC Laws¹) while a CEREIF is a collection of assets under the fiduciary management of a management company.

¹ JSC Law, ie the RF Federal Law on Joint Stock Companies No. 208-FZ dated 26 December 1995 (as amended).

REIFs for qualified investors

28.112 The 2007 amendments to the legislation on REIFs introduced the concept of REIFS for qualified investors with less stringent requirements to the composition of assets in funds made up of such qualified investors. The threshold to fall into the category of a qualified investor is relatively low. Individuals who have invested not less than €81,000 in securities and corporate entities who have invested not less than €3,000,000 in securities fall under the category of qualified investors. Securities may comprise state and

municipal bonds, corporate shares and bonds, depositary receipts, investments units, derivatives and options, traded on Russian stock exchanges.

Fiduciary management agreement

28.113 The fiduciary management agreement (the 'Agreement') is the main document governing the operation of the REIF and contains, among other things, the terms and conditions of the REIF's operations, the rights and obligations of the management company and the rights of investors. The provisions of the Agreement (which are also referred to as the rules of fiduciary management) are determined by the management company and must comply with statutory requirements. The Agreement and any changes thereto must be registered with the FSFM in order to be effective. Investors agree to the terms and conditions of the Agreement by buying investment units in the REIF. The Agreement can allow investors to demand redemption of all or part of their investment units, thus ending their involvement in the REIF, although restrictions on the ability of investors to redeem their investment units may be incorporated. The term of the Agreement can range from three to fifteen years, with an option to extend the term if the investors have not demanded redemption of all units at the end of the term.

Investment declaration

28.114 The investment declaration is a document describing the investment policy of the management company engaged by the REIF; the investment objectives for the REIF; the description of risks connected with investing into the REIF; and any restrictions on the composition of the assets of the REIF. This ensures that the investors are aware of precisely what the REIF intends to invest in and what the REIF can and cannot invest in.

Composition and structure of REIF assets

28.115 The Funds Law and the FSFM regulation¹ provide for the requirements to the composition and structure of REIFs.

¹ FSFM Order No. 08-19/pz-n dated 20 May 2008.

28.116 The assets of a REIF can comprise:

- cash deposits;
- real estate property (including lease rights);
- rights arising from contracts of participation in shared construction projects;
- debt instruments;
- investment units of other joint stock or closed-end (real estate or rent) investment funds;
- securities of foreign REITs;
- rights arising from investment construction contracts;

- rights under construction or reconstruction contracts;
- majority interests in Russian commercial companies involved in construction business (the REIF must own over 50% of the shares in such companies); and
- project documentation.

It is worth noting that mortgaged or pledged property cannot comprise assets of the REIF.

Management company

28.117 The management company manages the REIF's assets in its own name (which includes, for example, buying, selling and leasing assets where appropriate), although it must specify that it is acting in its capacity as a fiduciary manager when so doing. The Agreement may stipulate that certain transactions require the approval of the REIF's investment committee. The liability of a management company is limited to real losses suffered by the owners of investment units as a result of the management company breaching the rules of fiduciary management, the Funds Law or other federal laws. Debts arising out of fiduciary management of the fund's assets are paid out of such assets, provided the management company has properly incurred such debts. The management company must ensure that the REIF's assets are segregated from the other property of the management company to ensure that the REIF's assets are not included in the management company's estate following its insolvency.

General owners' meeting

28.118 The general meeting of the owners of the REIF's investment units will be called to take votes from unitholders on important issues such as a change of the management company or an amendment to or termination of the Agreement. The management company, the specialised depositary or owners of investment units may convene the meeting.

Roles of service companies

28.119 The REIF's operations also require involvement of specialised service companies, including the depositary, the registrar, the appraiser and the auditor. The depositary keeps records of the fund's property and holds title deeds and other evidence of the REIF's ownership of assets. It also controls the transactions of the REIF and therefore provides an additional comfort that the REIF's rules and the investment declaration are being complied with. The registrar keeps the register of investment units. The depositary can also perform this role. Both the depositary and the registrar must possess FSFM licences before they are permitted to carry out their roles. The appraiser periodically evaluates the value of property comprising the REIF's assets and the auditor conducts annual audit of the REIF.

Termination of the REIF

28.120 The REIF is terminated if:

- all investment units are redeemed;
- the management company's or the depositary's licence is cancelled and a new management company or depositary is not appointed within three months from the date of such cancellation;
- the term of the Agreement has expired and the term has not been extended;
- the management company decides to terminate the REIF (if the Agreement permits it to do so); or
- other grounds stipulated by the Funds Law occur.

Disclosure requirements

28.121 The Funds Law and FSFM regulations impose disclosure requirements upon distribution of information about REIFs. The Funds Law also imposes a requirement on management companies and specialised depositories to regularly submit reports to the FSFM. These reports enable the FSFM to monitor the performance of the management company.

Taxation of CEREIFs

28.122 Investment in a CEREIF provides certain tax privileges. Following the amendments to the Russian Tax Code which came into force on 1 January 2008¹, it is clear that property transferred to the CEREIF's estate is exempted from corporate property tax. No tax is levied on any capital gain made by CEREIFs since they are not legal entities. Investors pay tax on the capital gain realised upon sale or redemption of their investment units. Transactions involving investment units of CEREIFs are also exempted from VAT. These tax benefits provide major incentives for investors and make investment in a CEREIF a tax efficient way for investors to gain exposure to real estate.

¹ The RF Federal Law No. 216-FZ dated 24 July 2007 on the introduction of amendments and changes to the Russian Tax Code.

CONCLUSION

28.123 This Chapter has demonstrated that the Russian domestic regulatory environment has been active in catching up with international standards and that the Russian regulation of real estate has made impressive progress since the early 1990s when there was no effective system of registration of ownership titles to real estate. New legislation in financial areas such as securitisation and investment funds has been adopted and modernised.

28.124 Furthermore, the new Russian administration has announced plans to make Moscow a leading international financial centre and to modernise civil

legislation in order to keep up with the requirements of the modern economy and international standards¹. However, although there have been numerous legislative developments relating to the ownership of real estate, other aspects of the relevant legal framework have not evolved at the same pace and further improvement of regulation would be beneficial in many areas. For example, the areas of law dealing with security offerings, insolvency and enforcement in relation to real estate are relatively underdeveloped in the Russian Federation compared with European jurisdictions, although they look advanced when compared to other countries from the Commonwealth of Independent States region. Despite this observation however, there is a developing political will to implement additional worthwhile real estate regulation. Together, all these developments will hopefully result in significant improvements to the regulation of real estate financings in Russia and as a result the Russian real estate market will continue to be viewed as a successful emerging market in terms of growth rate and possibilities for investors.

¹ See for example, Decree of the RF President No. 1108 dated 18 July 2008 on modernisation of the Civil Code of the Russian Federation.