

Russia

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MARKET OVERVIEW

High-yield debt securities versus bank loans

- 1 | Discuss the major differences between high-yield debt securities and bank loans in your jurisdiction. What are some of the critical advantages and disadvantages?

Under a bank loan agreement, the lending party is a single bank or a banking syndicate. This structure provides an opportunity to alter the loan terms by obtaining the relevant consent from the lending bank (or banking syndicate).

When issuing high-yield debt securities an issuer enters into a legal relationship with multiple lenders. In this regard if the issuer faces financial difficulties, the negotiation process is more cumbersome, requiring more time and bigger expenses.

On the other hand, high-yield debt securities provide access to new funding markets. In addition, issuers' covenants to lenders under high-yield debt securities are generally less strict than borrowers' covenants under bank loans, especially financial covenants.

It is also worth noting that, unlike a borrower under a bank loan, a bond issuer would in most cases be subject to information disclosure requirements. A requirement to disclose certain sensitive information to the general public could be a critical point for certain companies, especially considering the matter of international sanctions. This would be an important issue to consider when choosing a funding method.

Issuance of high-yield debt securities would be governed by Russian law, whereas a loan may be governed by Russian law or by English law.

For investors, it is important that high-yield debt securities have higher liquidity, and in most cases are traded on stock, which facilitates their trade. Bank loans are not traded on an organised market, which makes the transfer of loans more complicated. In addition, the transfer of loan sometimes requires the borrower's consent.

Regulation

- 2 | Are you seeing increased regulation regarding either high-yield debt securities or bank loans in your jurisdiction?

The high-yield debt securities market is relatively new for Russia. The market started to develop between 2016 and 2017. The Central Bank (regulatory authority) is currently working on promoting these kinds of instruments for small and medium-sized enterprises.

At the end of 2018 a bill was passed that was designed to simplify the procedure for issuance of securities, including high-yield debt securities. However, the bill addresses the capital markets in general rather than being focused on high-yield debt securities market. No increase in regulation targeting high-yield debt securities in particular is currently being seen.

It is worth mentioning that since 2016 the amendments introduced to the law and the stock exchange have ensured that almost any high-yield debt securities require that a bondholders' representative is appointed (an analogue of trustee in Russian law) in order to maintain the issuer's control in the interests of bondholders.

Current market activity

- 3 | Describe the current market activity and trends in your jurisdiction relating to high-yield debt securities financings.

The high-yield debt securities market has demonstrated significant growth over the past few years. There are plans to provide state support, and the Ministry for Economic Development has suggested introducing subsidies to cover expenses on bond issuance, as well as subsidies related to coupon payments. It is expected that the joint-stock company 'Russian small and medium business corporation' will be hugely involved in the issuance of bonds, including high-yield bonds. One of the possible forms of its involvement would be providing guarantees for bonds.

There are three main industries in the high-yield debt securities market: leasing, construction and microfinance organisations. Other issuers come from various industries, such as bank financing, agriculture, energy, or metalworking, etc.

An important characteristic of the high-yield debt securities market is an absence of institutional investors in the market. The vast majority of investors are individuals. It is worth mentioning that the government is making a major effort to bring individuals to the financial markets, which includes introducing special tax deductions. The reason for this could be a need for diversification of the limited sources of funding after sanctions were imposed on the Russian economy.

On the other hand, the level of involvement of individuals into investing in loan financing is extremely low compared to that of institutional investors and corporate investors and, therefore, we see the groups of investors involved in the high-yield debt securities market and in the loan financing market are not the same.

Currently high-yield bonds are unsecured. At present a significant number of issues have no guarantees, no collateral and no covenants. The investors are fully exposed to the issuer's default risk.

Main participants

- 4 | Identify the main participants in a high-yield debt financing in your jurisdiction and outline their roles and fees.

We see no actual cases where rating agencies would actively participate in the high-yield bonds market as this market is concentrated in a segment of unsecured bonds issued by companies unable to obtain any rating. Obtaining a rating for an issue of high-yield debt securities would be a rare exception.

In addition, institutional investors are currently staying away from high-yield debt securities, which decreases the need to obtain an investment rating.

The following are currently significant to the issuers of securities:

- A pool of securities distributors (generally represented by average local brokers). European securities market participants are not involved in issuance of high-yield debt securities. There is a specific class of local arrangers specialising in high-yield debt securities issues.
- A bondholder representative should be appointed for most kinds of high-yield debt securities issues due to regulatory requirements.
- Market regulation – most of these bond issues undergo registration in the Moscow Stock Exchange and the National Settlement Depository, and therefore the listing rules of the Moscow Stock Exchange are significant.

New trends

5 | Please describe any new trends as they relate to the covenant package, structure, regulatory review or other aspects of high-yield debt securities.

A new approach to regulating qualified investor status is currently being developed. It is quite possible that the new regulations will limit the involvement of individuals who do not possess qualified investor status in the high-yield debt securities market. More and more issues include covenants, which are expected to become common practice in the future.

New issuances contain more covenants than the old ones. These include change of control, limitation on indebtedness (eg, debt/EBITDA, EBITDA/interest expense), events of default (eg, cross-default that can include bankruptcy of the issuer or its subsidiaries, not paying principal on time, etc) and failure to meet disclosure requirements. We do not see any new trends in the structure of high-yield debt securities issuances. The main thing to note about the structure of Russian high-yield debt bonds is there are no issuances with the seniority that could determine the classes of creditors.

DOCUMENTATION TERMS

Issuance

6 | How are high-yield debt securities issued in your jurisdiction? Are there particular precedents or models that companies and investors tend to review prior to issuing the securities?

Typically, high-yield debt securities are corporate bonds that are registered by a stock exchange in the form of exchange-traded bonds or commercial bonds. Commercial bonds are the other form of corporate bonds that are registered by National Settlement Depository and these issuances do not have a prospectus. Commercial bonds are instruments that are sold on the OTC market via private placement. The other advantages of commercial bonds are the lack of requirements regarding the borrower's financial standing and disclosure requirements, the unsecured nature of borrowing, and the absence of restrictions as to the amount and timing of borrowing.

If an issuer plans to issue high-yield debt securities that are registered by a stock exchange, the documentation package includes an application, decision on issuance of bonds, prospectus and some formal documents regarding the issuer (including a copy of the shareholders' decision, the certificate of incorporation, etc). The main document of issuance contains all the terms and conditions of the security, including the rights of the bondholders and details of the security placement. After the decision and prospectus (if applicable) are registered on the stock exchange, the issuer files an application for listing with a set

of documents depending on the requirements of a particular stock exchange and level of listing.

If an issuer plans to issue high-yield debt securities that are registered by a National Settlement Depository, the documentation package includes an application, a decision on the issuance of bonds (in the form of a programme of commercial bonds) and formal documents regarding the issuer. No prospectus is required. After the decision on issuance of bonds is registered and the identification number is obtained the bonds may be placed via private placement on the OTC market.

Maturity and call structure

7 | What is the typical maturity and call structure of a high-yield debt security? Are high-yield securities frequently issued with original issue discount? Describe any yield protection provisions typically included in the high-yield debt securities documentation.

The typical maturity of high-yield debt securities is three to five years with an annual call option. We do not see any issue discount in high-yield debt securities issuances. High-yield debt bondholders rights may be protected by covenants, call provisions and by a bond representative.

Offerings

8 | How are high-yield debt securities offerings launched, priced and closed? How are coupons determined? Do you typically see fixed or floating rates?

As described above, the procedure depends on the type of high-yield debt bonds and the registration body (stock exchange or National Settlement Depository). A public offering is not permitted until the registration of prospectus (if required). The placement of bonds may be performed during a placement period and should be only after full payment is received. If issuance is placed on stock exchange settlements should be processed under clearing and other applicable rules of stock exchange. Coupons are typically determined by the issuer before the placement of bonds. On the Russian high-yield debt securities market we currently see only fixed rates.

Covenants

9 | Describe the main covenants restricting the operation of the debtor's business in a typical high-yield debt securities transaction. Have you been seeing a convergence of covenants between the high-yield and bank markets?

The main covenants are the following:

- Change of control – this allows bondholders to redeem the bond when a specified event has changed the ownership or control of the company that issued the securities.
- Limitation on indebtedness – the most frequently used ratios are leverage (debt/EBITDA) and interest coverage (EBITDA/interest expense). This covenant allows the bondholders to restrict an issuer from borrowing beyond a prescribed level during the maturity of bonds.
- Default events – these can include bankruptcy of the issuer or its subsidiaries, not paying the principal on time, etc. The typical grace period for missed payments to the other issuer's obligations (cross-default) is five days, allowing the issuer to prevent default.
- Failure to meet disclosure requirements, including annual accounting reports.

These covenants are also typical for bank loans.

- 10 | Are you seeing any tightening of covenants or are you seeing investor protections being eroded? Are terms of covenants often changed between the launch and pricing of an offering?

There has been a tightening of covenants as the market of high-yield debt securities has developed. Also, the universe of covenants of particular issuance depends on the underwriter and its reputation.

Terms of covenants are often determined in a decision on issuance of securities and are not changed after registration.

- 11 | Are there particular covenants that are looser or tighter, based on a particular industry sector?

We do not see any particular covenants that are tighter or looser, based on a particular industry sector.

Change of control

- 12 | Do changes of control, asset sales or similar typically trigger any prepayment requirements?

No, these covenants typically do not trigger any prepayment requirements.

- 13 | Do you see the inclusion of 'double trigger' change of control provisions tied to a ratings downgrade?

We do not see the inclusion of 'double trigger' change of control provisions tied to a ratings downgrade.

Crossover covenants

- 14 | Is there the concept of a 'crossover' covenant package in your jurisdiction for issuers who are on the verge of being investment grade? And if so, what are some of the key covenant differences?

There is no concept of a 'crossover' covenant package in Russian jurisdiction for issuers who are on the verge of being investment grade.

REGULATION

Disclosure requirements

- 15 | Describe the disclosure requirements applicable to high-yield debt securities financings. Is there a particular regulatory body that reviews or approves such disclosure requirements?

Russian law does not provide for any specific requirements related to high-yield debt securities. The issuers are subject to general requirements. If the securities have been admitted to on-exchange trading, the issuer is required to disclose information under a special procedure. Most of the bond issues are valued at under 1 billion roubles. Therefore, the issuers are not required to disclose a prospectus and are only required to disclose a memorandum. Unlike the requirements to a prospectus that are established by the Central Bank of Russia, the requirements to a memorandum are set in the rules of the stock exchange, so the memorandum needs to be approved by the stock exchange.

Club deals are another possible way of issuing commercial bonds. In this case the issuer would be subject to minimum disclosure requirements that cause the least expense.

Use of proceeds

- 16 | Are there any limitations on the use of proceeds from an issuance of high-yield securities by an issuer?

Imposing limitations on the use of proceeds from an issuance of high-yield securities by an issuer is not a common practice in the Russian securities market. The targeted use of funds is a requirement that could be found in securitisation deals or infrastructure products. However, this kind of limitation could possibly be used in high-yield debt securities as well.

Restrictions on investment

- 17 | On what grounds, if any, could an investor be precluded from investing in high-yield securities?

As the vast majority of investors in high-yield debt securities are individuals, an investor could be precluded from investing in high-yield debt securities if they lack qualified investor status.

Investors are required to possess this status to invest in debt securities if the issuer's net asset value is below the amount of its charter capital, or the issuer is showing signs of insolvency at the time of bond issuance. Application of the Basel principles makes investing in high-yield debt securities more complicated for banks.

Closing mechanics

- 18 | Are there any particular closing mechanics in your jurisdiction that an issuer of high-yield debt securities should be aware of?

Russian law does not provide for particular closing mechanics for high-yield debt securities. High-yield debt securities are to be recorded and deposited in the National Settlement Depository irrespective of the way they were offered.

GUARANTEES AND SECURITY

Guarantees

- 19 | Outline how guarantees among companies in a group typically operate in a high-yield deal in your jurisdiction. Are there limitations on guarantees?

There are high-yield debt securities issues where a parent company provides a guarantee against its' subsidiary's default. However, in most cases no guarantee is provided. As for the specific rules, it is worth noting that there is a requirement under which in most cases these transactions are to be approved as major transactions to comply with Russian company law.

It should also be considered that only certain parties may act as surety under a suretyship agreement securing a bond issue, namely commercial organisations with net asset value equal to or exceeding the amount of surety to be provided. Therefore, there is a limited opportunity to use surety in certain transactions.

Collateral package

- 20 | What is the typical collateral package for high-yield debt securities in your jurisdiction?

The current regulations allow for registration of bonds by the Central Bank of Russia, by the Moscow Stock Exchange (for bonds that qualify as exchange bonds), or by the National Settlement Depository (for bonds that qualify as commercial bonds). Exchange bonds and commercial bonds undergo a simplified procedure of bond issuance. Therefore, the high-yield debt securities are usually issued as exchange or commercial

bonds. However, these types of bonds are not allowed to be secured by pledge.

There are currently no bond issues secured by pledge in the high-yield debt securities market. In theory, if the bond issue undergoes registration with the Central Bank of Russia, this issue could be secured by pledge, however, the market decided to choose another direction. It is worth noting that securing an obligation by pledge is typical for a bank loan, but quite uncommon for Russian bond market (except for specific complex bond issues).

Limitations

- 21 | Are there any limitations on security that can be granted to secure high-yield securities in your jurisdiction? Are there any limitations on types of assets that can be pledged as collateral? Are there any limitations on which entities can provide security?

This is currently not applicable due to the lack of high-yield bonds issues secured by pledge.

Collateral structure

- 22 | Describe the typical collateral structure in your jurisdiction. For example, is it common to see crossing lien deals between high-yield debt securities and bank agreements?

As mentioned above, high-yield debt securities are not commonly secured by pledge. In addition, banks do not invest in high-yield debt securities.

Legal expenses

- 23 | Who typically bears the costs of legal expenses related to security interests?

Typically, all costs relating to the security are paid by the issuer.

Security interests

- 24 | How are security interests recorded? Is there a public register?

The information about pledge is directly stated in the bond decision, which in this case becomes a pledge agreement. In addition, in Russia a public registry of pledges is maintained. It is common practice that the issuer makes an entry regarding the pledge in this register but it is not applicable for high-yield debt securities, in view of bonds being issued unsecured.

In addition, information about mortgages is reflected in the unified state register of real estate.

- 25 | How are security interests typically enforced in the high-yield context?

If high-yield debt securities were secured by pledge, the enforcement procedure would normally mean that the issuer is required to appoint a bondholders' representative, and optimally this would take place in the following order: in the event of default, the bondholders' representative may enforce the pledge at his or her own initiative or at the bondholders' requirement. This order provides for centralised enforcement. The collected amounts are transferred to the account of the bondholders' representative with the National Settlement Depository. After that the funds are distributed proportionately among the bondholders.

DEBT SENIORITY AND INTERCREDITOR ARRANGEMENTS

Rank of high-yield debt

- 26 | How does high-yield debt rank in relation to other creditor interests?

There is a lack of effective rules regulating intercreditor arrangements in Russia, as the bankruptcy legislation does not provide for an opportunity to alter the order of claims in the event of the issuer's bankruptcy.

However, in most cases high-yield debt securities would be subordinated to bank lenders contractually, as banks hold the collateral securing the issuer's obligations under loans.

Besides, if at the time of issuing the high-yield debt securities bondholders rank *pari passu* with banks, the issuer can at any time provide collateral to its creditors, which would lower the rank of high-yield debt securities.

Regulation of voting and control

- 27 | Describe how intercreditor arrangements entered into by companies in your jurisdiction typically regulate voting and control between holders of high-yield debt securities and bank lenders?

The relationships among the creditors with respect to the issuer's obligations are governed by an intercreditor agreement that addresses such issues as voting rights, notifications of default, etc. The voting rights could be exercised by bondholders via a bondholder's representative. Currently there are no intercreditor agreements in the high-yield debt securities market because all high-yield debt securities are unsecured. Russian legislation does not provide for the possibility of changing the priority of creditors' claims governed by Federal Law 'On Insolvency (Bankruptcy)' by agreement.

As per the provisions of article 309.1 of the Civil Code there is a possibility of entering into an intercreditor agreement, but this agreement regulates just transferring the performance to the other creditor if the performance was received in breach of the agreement and does not change the priority of creditors' claims during the bankruptcy process.

TAX CONSIDERATIONS

Offsetting of interest payments

- 28 | May issuers set off interest payments on their securities against their tax liability? Are there any special considerations for the high-yield market?

Under Russian law, the coupon payment under bonds, including high-yield debt securities, may be set off against the issuer's tax liability. Obviously the set off is not possible in relation to the interest on a loan issued to the company by an entity that is a part of the same group. In this case, the thin capitalisation rule is applied.

There are no special tax considerations for the high-yield market in relation to set off interest expenses.

Tax rulings

- 29 | Is it common for issuers to obtain a tax ruling from the competent authority in your jurisdiction in connection with the issuance of high-yield bonds?

It is uncommon for issuers to obtain tax rulings in connection with the issuance of securities, including high-yield bonds.

UPDATE AND TRENDS**Current Developments****30 | What are your expectations for the year ahead?**

We expect that the high-yield debt securities market will continue to grow in the near future, including through the involvement of small and medium-sized enterprises.

The necessary infrastructure will continue to evolve. The Cbonds-CBI RU High-Yield index was introduced in late 2018.

It is worth noting that high-yield bond issues are significantly different in size than other corporate bond issues. Minimum bond issues are less than US\$500,000, while the standard issue of bonds starts at US\$15 million.

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