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BLOCKCHAIN

The Rising Interest in Blockchain Technologies, Amid Legal Issues in Russia



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Rising Interest in
Blockchain Technologies
in Russia

MOSCOW – Blockchain technologies are attracting increased interest from Russian financial institutions and IT companies, and may be poised to overcome skepticism from Russian regulators. This is perhaps not surprising, given Russia's prominence in the technology sector, with over 120,000 local programmers and continuing growth in ecommerce and online activities. However, certain legal obstacles may still pose challenges for promoters and developers of cryptocurrencies and other blockchain applications.

Current Resistance to Bitcoin. The Russian authorities have given attention to potential uses of cryptocurrencies for several years, but until recently the focus was on anti-corruption and anti-money laundering measures, legal compliance and risk management. The Central Bank and Ministry of Finance have played leading roles in consideration of these issues.

Russian law currently states that the Ruble is the national currency, and that the issuance of other currencies or “currency surrogates” on Russian territory is prohibited. Some Russian officials have argued that cryptocurrencies should be treated as surrogates, but this point remains controversial. In 2014, the Central Bank issued a formal letter noting that the trading of goods or services for “virtual currencies,” as well as the conversion of such currencies to Rubles or foreign currencies, could be used for money laundering and terrorist financing. While this warning did not have the force of law, it served to put Russian banks and companies on notice that transactions with cryptocurrencies are likely to be subject to special scrutiny.

Proposed Amendments. In early 2016, the Russian authorities appeared ready to go further in moving against cryptocurrencies. Reportedly, the Ministry of Finance prepared draft amendments to existing laws that would impose administrative fines and criminal penalties for the issuance, purchase or sale of Bitcoins. These would include fines of up to 2.5 million Rubles (about US\$39,000 at current FX rates) for financial organizations and imprisonment of up to seven years for senior managers. Certain other Russian governmental bodies expressed support for these proposals, including the Ministry of Economic Development and the Investigative Committee, a federal agency with authority over criminal investigations.

However, it appears that the Russian Government has decided not to pursue these amendments, for several reasons. First, it was reported that certain key players such as the Ministry of Justice and the federal Prosecutor’s Office did not support the proposed imposition of criminal liability. Some observers argued that existing Russian laws would be sufficient to deal with criminal activity, without establishing a separate rule based solely on use of cryptocurrencies.

Second, Russia is now exploring the potential advantages of the relevant technologies behind Bitcoin and other cryptocurrencies. Accordingly, some Russian authorities are working on new legal reforms to provide a legitimate basis for the use and development of cryptocurrencies. Proponents include Herman Gref, the chairman of Russian banking giant Sberbank and a former Minister of Economics and Trade. Mr. Gref has argued that if Russia bans cryptocurrencies, it will risk falling behind in innovations related to blockchain and similar technologies. Other Russian officials have also expressed interest in blockchain, and further progress is expected on this front in 2017.

Current Activity; Masterchain. A concrete example of Russian interest in blockchain technologies is “Masterchain.” Commencing in fall 2015, the Russian Central Bank established a working group to study blockchain technologies and explore potential practical applications, with emphasis on financial markets. This led to efforts to establish a prototype distributed database for financial messaging. In 2016, a consortium including Russian payments company Qiwi, Accenture and four Russian financial organizations began testing blockchain technologies in cooperation with the Central Bank. The work of the consortium resulted in Masterchain, an Ethereum-based blockchain prototype for the validation and exchange of client data and transactional information. In contrast to Ethereum, Masterchain is a permissioned (private) database of chained blocks of data. The Central Bank of Russia acts simultaneously as an ordinary user in payment processing and a trusted administrator.

The next step may be to develop further prototypes. Central Bank officials are currently examining two other proposed versions of Masterchain. One is Ethereum-based and uses a proof of work (POW) consensus algorithm (to be replaced with a proof of stake (POS) algorithm when Ethereum switches to POS). The second already uses the POS algorithm. A group of 10 Russian financial organizations will test these products, with the goal of eventual commercial use.

Another Russian proposal is to establish a professional association called “FinTech”, which would assist in drafting legal reforms to regulate blockchain technologies. Representatives of various governmental agencies would participate. The new body would address various applications of blockchain technologies, such as electronic voting, notary systems, maintenance of shareholder, real estate and other statutory registers, and validation of client data and transactional information.

Other Russian organizations and business leaders are also becoming active. The National Settlement Depository, Russia’s central securities depository, has initiated a pilot e-proxy shareholder voting project using a permissioned blockchain solution. In addition, the Perm State National Research University has opened a laboratory to study “crypto-economics” and blockchain systems; a prominent Russian entrepreneur has invested in the BlockGeeks social media platform; and Russian payments company Qiwi plans to upgrade its core database to a distributed ledger system within five years.

Smart Contracts. The use of blockchain technologies for the formation and implementation of “smart contracts” has also attracted interest in Russia, but may require further legal reforms. Russia has already begun incorporating applications for modern technologies into its civil laws and contract practices. For example, Russian law allows parties to enter into contracts by the exchange of electronic documents through e-mail or other means. However, in some cases it may be advisable to create a separate physical document to establish the legal basis for subsequent electronic communications. The use of various types of electronic signatures is also authorized, under rules like the 1999 EU Electronic Signatures Directive. (Certain verification keys may require certification by the Russian communications authorities.)

In addition, a number of Russian governmental bodies have modernized their operations to facilitate the exchange of documents via online platforms, such as electronic submission of tax declarations, accounting reports and license and patent applications. These include the Federal Tax Service, Federal Service for Intellectual Property, and Federal Service for Supervision of Communications, Information Technology and Mass Media. Notary filings may be submitted electronically, and the state companies register is accessible online.

Nonetheless, in some respects Russia remains a tradition-bound market in which physical documents, seals and stamps are essential. In particular, the transition to distributed ledger systems and virtual contracts will conflict with existing, centralized registers that are legally required for certain transactions. An example is the sale of “participation interests” in a Russian limited liability company (LLC) which is effected by notarial certification of the written sale contract, and recording of the corresponding entry into the state register. For sales of shares in stock companies, the transfer must be recorded in a separate register, typically kept by an independent service provider. While Russian courts are also joining the digital revolution – for example, some hearings and decisions are now accessible online – they are more traditional with respect to evidentiary matters. Generally, the courts require the production of physical originals or certified

copies of documents, and it is not clear how virtual contracts should be documented for these purposes.

In theory, blockchain solutions could be proposed to address some of these issues, for example to replace notarial certification and the use of central registers. They would also facilitate due diligence, as a prospective buyer could verify all prior share transactions. However, full adoption of blockchain solutions would entail further Russian legal reforms. For example, it is not clear how the use of Decentralized Autonomous Organizations (DAOs) or similar arrangements, where contracts are implemented by use of pre-written codes, would be interpreted under Russian contract rules, either from the perspective of enforceability or imposing liability for breaches. Occurrences of breach or fraud within the decentralized blockchain could also raise novel questions of jurisdiction and governing law without precedent in Russia.

These matters will require further attention from Russian officials, IT developers, lawyers, and other market participants. Ultimately, if Russia decides to play an active role in the development of blockchain technologies, then the necessary legal changes are likely to follow.

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