

The new regulation of construction activities

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Russia

Pursuant to Federal Law No. 148-FZ dated 22 July 2008, no surveying, design or construction licences have been issued since 1 January 2009. With effect from 1 January 2010, only companies that are certified by so called "self-regulating organisations" ("SROs") will be entitled to engage in construction activities.

These new measures were implemented as part of the effort to cut red tape and liberalise the construction market in Russia. This is in line with the general trend of Russia's policy to limit direct government intervention in the economy, especially in specific sectors.

To date, the self-regulating scheme has been tested on court-appointed receivers and appraisers and is thought to be generally successful.

In addition to making the construction business a self-regulated one, similar measures are contemplated for other industries, such as cargo-carriage as a matter of example.

However, the reforms in the construction sector are the largest experiment of self-regulation of the Russian market so far.

We can assume that the successes and difficulties experienced in reforming this industry will largely shape the future approach of Russian authorities in respect of other activities.

As a starting point, we will briefly review the key components of the reform. We will then expose the main issues of concern for the construction community in connection with this reform.

A new regulatory scheme

The key elements in this new scheme are the SROs themselves, which are established as non-profit partnerships. Legal entities intending to carry on construction activities in Russia must be "admitted" as members of these SROs.

As members of a non-profit partnership, they must establish a compensatory fund to serve as a financial guarantee of their good standing. Money in this fund is intended to secure secondary liability incurred by the SRO for any damage caused by defects in the works completed by its members. In other words, if a construction company does not have sufficient funds to cover its liability, the aggrieved party may claim compensation from the SRO.

There are three types of SROs:

- SROs whose members are involved in surveying activities;
- SROs whose members are involved in designing activities; and
- SROs whose members are involved in construction activities.

Depending on the form of the SRO, the law sets out different requirements as to the number of members and the amount of the compensatory fund: surveyors' and designers' SROs must have at least 50 members; constructors' SROs must count at least 100 members. The compensatory fund of surveyors' and designers' SROs must be of at least RUB 500,000 per member and the compensatory fund of constructors' SROs must be of at least RUB 1,000,000 per member. The monetary value of a compensatory fund may be reduced if the SRO requires its members to take out third-party liability insurance. In this case, contributions to the compensatory fund may be reduced to RUB 150,000 per member for surveyors' and designers' SROs and to RUB 300,000 per member for constructors' SROs.

Compensatory funds must be either placed on deposit with a bank or on trust with a managing company. The money should be readily available in case enforcement is initiated.

Every SRO must be entered into a special SRO register which is currently held by the Federal Service for Environmental, Technological and Nuclear Supervision ("Rostekhnadzor").

The SRO register is public and can be accessed on Rostekhnadzor's website (www.gosnadzor.ru). The register's rules and regulations are set forth in Resolution of the RF Government No. 724 dated 29 September 2008.

Once it is duly registered, an SRO becomes entitled to issue **admission certificates allowing its bearer to perform listed surveying, design or construction activities**. An admission certificate is a document certifying the right of an SRO member to perform the work for which it has been accredited, provided that it complies with legal and regulatory requirements and the SRO's internal regulations. Subject to the conditions described hereunder, admission to an SRO is granted for an indefinite term and free of charge.

SROs are responsible for monitoring their members' compliance with the applicable regulatory requirements. SRO members found in breach of said requirements may be suspended or even have their certificates cancelled.

SROs must develop and approve **standard admission requirements** and define the **rules for monitoring** its members' compliance with legal and regulatory requirements, including Russian law construction standards and technical regulation.

SRO will need to adopt rules establishing the **disciplinary process** for its members' failure to comply with the SRO internal regulation and standards and the legal and regulatory requirement, including technical regulation.

The list of activities that can be certified by an SRO is set forth in Order of the RF Ministry for Regional Development No. 274 dated 9 December 2008. The list provides for 35 activities, including surveying, preparation of design documentation, construction, re-construction and capital repairs affecting the safety of buildings or constructed objects, etc.

Construction companies performing construction related activities without being admitted to an SRO will be held administratively liable (Article 9.5.1 of the Code of Administrative Offences) and punished by fine or administrative suspension of operations for up to 90 days. In addition, any documents they produce will not be accepted for state expert's review (*gosekspertiza*) and their works will not eligible for commissioning. Such unwarranted activities are also a criminal offence punishable by imprisonment for up to 5 years pursuant to Article 171 of the RF Criminal Code. The application of the latter provision of the criminal code may be challenged however, as its wording refers to formerly existing licences rather than to the new SRO admission procedure.

According to the authors of this reform, it will clear the Russian construction market of construction intermediaries and shell companies, contribute to shaping a good-faith competitive environment in the construction business and make construction companies accountable for any defective workmanship.

Challenges and progress of the reform

It should be noted that despite its valuable objectives, the reform is not progressing as smoothly as may have been anticipated.

According to varying estimates, as of today, only 15% of construction companies have joined an SRO.

This is partly due to the fact that many non-profit partnerships formed have not met the SRO registration requirements. This process should be completed within the two coming months.

On the other hand, there are a significant number of construction companies that have not yet decided which SRO they will join and when.

The reason for such a delay is arguably due to the fact that some companies hope or believe that the period during which licences (old regime) and SRO admissions (new regime) may co-exist will be extended. Indeed, such was the case in relation to the abolition of previous regulation on licensing, which was systematically postponed for several years.

Nevertheless, some experts maintain that the introduction of the self-regulating scheme is an irrevocable decision of Russian authorities and that such extension is unlikely. Furthermore, they argue that any time extension of the transitional period will not change the general development trend and the need to join an SRO will arise sooner or later.

At the same time, the reform is not without criticism. For example, and despite government's objectives, some argue that corruption will shift simply from licensing centres to SROs and that the SRO system will result in unfair competition practices.

Another extensively discussed issue is that the reform provides for different SROs for surveyors, designers and constructors. In practice, many companies are engaged in at least two of these activities (for example, design and construction), and as such, they will have to join two or even three different SROs under the proposed scheme.

This would add to a company's costs, as SRO members will be required to pay membership fees to finance the SRO's operations, in addition to compensatory fund contributions. As a result, a legislative change to provide for comprehensive SROs issuing admissions to all construction-related activities is currently being discussed.

In practice, one solution to this problem would be to create legally distinct SROs, albeit with a unified organisational structure and administration, which would serve to minimise organisational costs.

Another problem is that the lists of activities to which SROs grant admission does not include the functions of general contractor, general designer and construction manager (*zakazchik-zastroyschik*), which are common for the construction market. This gap is expected to be addressed during this fall.

It is also alleged that SROs may potentially manipulate the construction market by setting different levels/standards of requirements for members' admissions (certification for activities or qualification or training for specialists, etc.) which would ultimately result in SROs having different quality standards, thus creating confusion in the market.

The efficiency of the compensatory fund and its adequacy for covering potential losses are also questioned. Although this measure is welcomed by small or individual companies, since lots of them did not carry any insurance coverage, in practice it is not adapted to companies involved in big projects for which investors or future landlords would require appropriate financial and insurance guarantees/coverage.

Despite the above concerns (many of which that do not appear completely unfounded), it should be admitted that the Russian authorities have been the driving force behind the reforms towards SROs, and that to date such reforms have

been gradually implemented. Currently, there is no reason to believe that this trend will change radically.

As a result, construction or surveying companies and their clients should prepare for the changes, which have actually occurred.

Construction or surveying companies should primarily address the issue of joining the relevant SROs, or SROs currently under formation. Their choice should be based on a pertinent analysis of their own capacities and of the standards of the SRO they would consider joining and its members.

It should be particularly noted that, despite the fact that foreign companies are legally capable of accession to SROs (see art. 55.6, para. 1 of RF City-planning Code) their involvement in these SROs may be problematic in practice. This is mainly because very few newly-created SROs have the experience of dealing with foreign companies operating in the Russian construction market.

An SRO membership implies active participation in its operations, specifically now that “the rules of the game” inside the SROs are being developed, e.g. internal requirements for granting admissions, conducting audits, HSE standards, training of specialists, etc.

In the short term, the construction community should prepare for greater uncertainties in the marketplace. Potentially, SROs could open up greater opportunities for a better regulated market, but these theoretical assumptions may be confirmed only through practice.

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