ACRA

# Methodology for Analyzing Relationships Between Rated Entities and the State under the International Scale

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# Contents

# 1 Scope of methodology

This Methodology for Analyzing Relationships Between Rated Entities and the State under the International Scale is used to evaluate the influence that the state represented by the national government, regional and municipal authorities as well as other government institutions has on creditworthiness of rated entities, i.e., both financial and non-financial organizations.

Not being a comprehensive document, this methodology contains references to other methodologies of the Analytical Credit Rating Agency (hereinafter – ACRA, or the Agency), in particular, to those for assigning credit ratings under the international scale. This methodology is inapplicable for ratings of regional and municipal authorities or small and medium-sized businesses.

Rated entities, whose standalone creditworthiness assessments (SCA) have to be adjusted depending on the influence that the state has on them, are regarded as government-related rated entities. This implies that creditworthiness of such rated entity is determined not only by its standalone creditability, but also by its systemic importance for the national economy as well as by state influence on operating activities, financial standing and ownership structure of the rated entity.

Before applying this methodology, a preliminary rated entity SCA calculation is typically required. For that purpose, methodologies covering specific types of rated entities are applied, with possible adjustments for the influence of the state represented by the national government or regional authorities. If it is impossible to assess SCA but a rated entity is characterized by a very high level of importance for the national or regional economy and there is a significant or very significant state influence, the Agency sets a parity between a credit rating of a rated entity and a credit rating (credit estimate) of the national government or applies a discount to it.

This methodology shall be applied on a permanent basis until a new edition is approved by the ACRA Methodology Committee.

Credit ratings assigned according to this methodology shall be revised in accordance with ACRA internal documents, but not later than 365 days past the date of the latest rating action.

In order to keep this methodology up to date, ACRA shall review and amend it in the following cases:

- over three instances of deviation from this methodology while performing rating activities over the course of one quarter;
- requirement for amendments based on the results of methodologies application monitoring conducted by the methodology group;
- request for immediate revision of this methodology filed by the Compliance and Internal Control Service of ACRA.

ACRA shall review this methodology in accordance with its internal documents within one calendar year after the latest review date. A review may bring amendments to the methodology, or leave it unchanged until the next review.

Any deviation from this methodology in the course of its application shall be documented and disclosed on ACRA's official website www.acra-ratings.com simultaneously with a credit rating or a credit rating outlook publication and with an indication of reasons for such deviation.

If any errors that already affected or may potentially affect credit ratings and/or credit rating outlooks are detected in this methodology, ACRA shall conduct its analysis and review in accordance with the established procedure. If errors discovered in this methodology may impact any previously assigned credit ratings, ACRA shall disclose such information on its official website www.acra-ratings.com.

If the planned amendments to this methodology are significant and affect or may potentially affect the current credit ratings, ACRA shall do the following:

1) send to the Bank of Russia and disclose on its official website www.acra-ratings.com the full information about the planned amendments to the current methodology, with an indication of reasons and consequences that such changes may entail, including impact on credit ratings assigned in accordance with this methodology;
2) assess the need for revision of all credit ratings assigned in accordance with this methodology within six months after the latest amendment date;
3) revise credit ratings within six months after the date of the assessment mentioned in the above paragraph, if the results of the assessment prove the need for their revision.

# 2 Methodology basic principles

The state possesses a wide range of instruments to support national issuers. This statement is based on the ability of national governments to issue money, manage budget reserve funds, amend existing legislation, in particular, establish tax burden, govern cross-border cash and trade flows, allocate tax revenues among budgets of various levels as well as control activities of corporate entities and financial institutions associated with the state. Consequently, the state can shift fiscal and other cash flows in its favor, thereby ensuring continuous cash inflows into the state budget for timely servicing and repayment of debt.

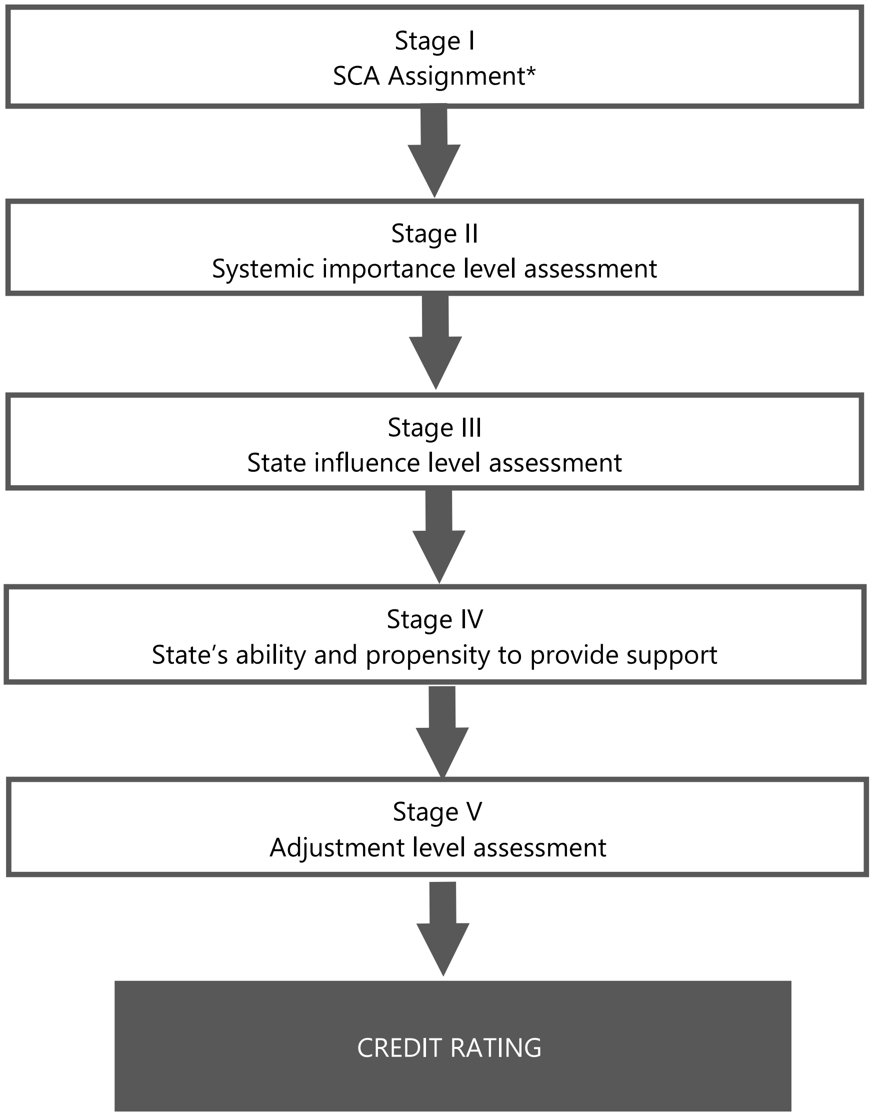
The main criterion that calls for SCA adjustments within the framework of this Methodology is the likelihood of state authorities providing extraordinary support to a government-related rated entity in the event of potential severe deterioration of the latter's finances.

A significant stake in the share capital of a rated entity owned by the state shall not be regarded as a necessary and sufficient condition for credit rating adjustment for state support. At that, within this methodology not only state support of rated entities under direct control of the state can be assessed, but also that of rated entities, not owned by the state.

If the state provides direct guarantees for financial obligations of a rated entity, ACRA regards risks of such instruments as equal to the level of a sovereign risk and assigns the respective rating to them. If the state guarantee covers only a part of financial obligations of a rated entity or its selected financial instruments, a rated entity's SCA shall not be automatically adjusted to the sovereign risk level.

# 3 Analysis structure

**Figure 1. Structure of analyzing relationships between a rated entity and the state**




* If it is deemed impossible or impractical to determine the rated entity’s SCA, Stage I can be omitted.

Source: ACRA

# 4 Analysis procedure

## 4.1. Systemic importance of a rated entity

In order to define the likelihood of state authorities providing support to a rated entity, ACRA analyses the latter's systemic importance for the national economy and social sphere.

If a rated entity is an integral part of the national economic infrastructure or if it performs socially important functions, it may be an indication of its systemic importance. Termination or malfunction of a systemically important rated entity may entail negative economic and social consequences for the national or regional economy and cause reputational damage to the government.

Criteria for assessing systemic importance may include not only rated entity's influence on functioning of separate sectors of economy or its economic role for a selected region, but also its importance as a source of income for national or regional budget.

The Agency distinguishes the following levels of systemic importance of rated entities:

- **Very high** — a rated entity is an integral part of the national economy or performs socially important functions.
- **High** — a rated entity is an important part of the national economy or performs socially important functions.
- **Medium** — termination of rated entity's operations will entail limited economic, social or reputational consequences for the national or regional economy.
- **Low** — termination of rated entity's operations will not entail negative economic, social or reputational consequences for the national or regional economy.

Systemic importance level is defined by the Agency in accordance with assessment of factors, summed up in Table 1.

**Table 1. Systemic importance assessment**

| Systemic importance factor | Weight | Assessment |
|---|---|---|
| **Financial stability** | 40 | 1 — deteriorating financial standing of rated entity (e.g. default of major financial institutions or institutions that are part of a state system guaranteeing against risks of financial instability) may trigger financial crisis;<br>2 — rated entity is a major financial institution, and deterioration in its financial standing may trigger long-term financial instability (outflow of depositors, crisis of credibility in the financial market, liquidity crisis);<br>3 — rated entity is among major non-financial companies, and its default would trigger crisis of credibility in the financial market and confidence to the state;<br>4 — default of rated entity may destabilize financial system, which may be cured by regulatory measures;<br>5 — default of rated entity may cause short-term volatility in financial markets but it would not impair financial stability in general. |
| **Social functions** | 20 | 1 — rated entity performs a socially important unique function, and it is a monopolist in such segment;<br>2 — rated entity performs a socially important unique function, and it is a dominant player in such segment;<br>3 — rated entity performs a socially important unique function, and it is a key player in such segment;<br>4 — rated entity performs a socially important unique function, and it is one of the players in such segment;<br>5 — rated entity performs no socially important unique functions. |
| **Economic policy** | 15 | 1 — rated entity performs monopolistic quasi-governmental functions in the economic development sphere (infrastructure development, support to economy sectors/exports, etc.);<br>2 — rated entity acts regularly as an agent in conducting state economic policy (large-scale projects, support to economy sectors);<br>3 — rated entity acts frequently as an agent in conducting state economic policy;<br>4 — rated entity acts rarely as an agent in conducting state economic policy;<br>5 — rated entity never acts as an agent in conducting state economic policy. |
| **National security** | 20 | Rated entity manufactures products vital for the national security (defense, food, energy), and its share in the national market is:<br>1 — monopolistic;<br>2 — key;<br>3 — significant;<br>4 — low;<br>5 — Rated entity manufactures no products vital for the national security (defense, food, energy). |

| | | |
|---|---|---|
| **Employment** | 10 | 1 — rated entity is a very large employer for socially exposed groups on the national scale;<br>2 — rated entity is the largest employer for socially exposed groups on the regional scale;<br>3 — rated entity is the largest employer in a large city;<br>4 — rated entity is the largest employer in a small mono-city;<br>5 — deterioration in financial standing of rated entity and relevant job cuts would not give rise to social tensions. |

Source: ACRA

The weights shall be summed up as follows: in case the factor score is 1 pt, the weight is added unchanged; in case the factor score is 2 pts, the weight is added multiplied by 0.75; in case the factor score is 3 pts, the weight is added multiplied by 0.5; in case the factor score is 4 pts, the weight is added multiplied by 0.25; in case the factor score is 5 pts, the weight is added multiplied by 0. As a result of weighing all the factors, a rated entity systemic importance shall be assigned to one of the above four levels: "Very high" (the sum exceeds 40), "High" (the sum is 20–40), "Medium" (the sum is 10–20) or "Low" (the sum is less than 10).

## 4.2. Level of state influence on a rated entity

When assessing a level of state influence on creditworthiness of a rated entity, the Agency relies upon economic nature of existing interrelation rather than on formal criteria of a legal status or exposure to state regulation.

ACRA distinguishes the following levels of state influence on a rated entity, which may lead to SCA adjustment:

- **Very strong influence**: operating activities and financial results of a rated entity fully depend on state decisions and actions.
- **Strong influence**: operating activities and financial results of a rated entity significantly depend on state decisions and actions.
- **Moderate influence**: operating activities and financial results of a rated entity (extraordinary support) depend on state decisions and actions in exceptional cases.
- **Weak influence**: operating activities and financial results of a rated entity depend on state decisions and actions in accordance with current legislation, which is taken into account with regard to SCA assignment in dedicated methodologies.

The level of state influence on creditworthiness of a rated entity is built on a number of factors including shareholder control as well as operational and financial control. ACRA takes into account not only the state's actual stake in the rated entity's share capital, which in itself is not a sufficient condition for very strong influence on a rated entity, but also the actual degree of the state involvement into its operating and financial activities. One of the key criteria is assessment of actual ongoing state support as well as its extraordinary support. State support may include direct financing of operating or capital expenditures, subsidizing tariffs or interest expenses, guarantying market debt obligations, taking part in state projects or other actions that help to improve rated entity's operating results. Main criteria, used by the Agency for assessing the level of state influence, are summed up in Table 2.

**Table 2. State influence level assessment**

| State influence level | Very strong (level 1) | Strong (level 2) | Moderate (level 3) | Weak (level 4) |
|---|---|---|---|---|
| **Control** | Shareholder and operating control | Operating control, no shareholder control | Shareholder control, no operating control | No control |
| **Ongoing support** | Ongoing direct subsidizing, investment program financing | Participation in state procurement and projects | Indirect support through demand stimulation | No ongoing support |
| **Extraordinary support** | Multiple cases of getting support from the state, willingness of the state to provide support in the shortest possible time | Several cases of getting support from the state in the past | One-off cases of getting support from the state | No cases of getting support from the state |

Source: ACRA

As a result of assigning and weighing (each having 33.3%) all the above factors, state influence on a rated entity shall be assigned to one of the above four levels: “Very strong”, “Strong”, “Moderate” or “Weak”.

If a significant part (above 70–80%) of a rated entity’s debt is guaranteed by a supporting state government body, or a rated entity’s budget allows for the debt servicing and repayment, the Agency reserves the right to expertly adjust the state government body’s influence upwards — up to the “Very strong” level.

## 4.3. State’s ability and propensity to provide support

State support may vary by jurisdiction or time period. The analysis shall be aimed at determining:

- Is the state support sufficient or limited?
- Would the state provide support and, if yes, to what extent?

The state’s ability to provide support is generally higher when the government has reserves or special-purpose anti-crisis funds, sovereign debt is insignificant, and the budget is well-balanced. In most cases, such states have high credit ratings (credit estimates) (see Table 3).

**Table 3. State's ability to provide support**

| | Factors that make the state's ability to provide support | |
|---|---|---|
| | **higher** | **lower** |
| **Credit rating (credit estimate) of a sovereign issuer, assigned by ACRA[1]** | Relatively high/high level of creditworthiness according to ACRA's international rating scale | Relatively low/low level of creditworthiness according to ACRA's international rating scale |
| **Reserves/funds** | Substantial reserves, anti-crisis funds, etc. | No reserves, anti-crisis funds, etc. |
| **Budget** | Surplus | Deficit |
| **Sovereign debt** | Debt load stability factor assessed as above average | Debt load stability factor assessed as below average[2] |

Source: ACRA

The state's propensity to provide support to national issuers is generally lower in mature economies, because such support may be considered a violation of market competition principle and give rise to blames in other taxpayers. In emerging economies, where state acts as an insurer against social and economic risks, the likelihood of extraordinary support is higher. Moreover, the likelihood of extraordinary support is higher in those countries where the share of budget revenues generated by rent taxes is high (e.g. from the extraction industry), as expenditures for non-social projects are less sensitive to public mood in such countries.

**Table 4. State's propensity to provide support**

| | Factors that impact the state's propensity to provide support | |
|---|---|---|
| | **positively** | **negatively** |
| **Budget expenditures** | Flexible budget rules allow higher expenditures for priority purposes | Inflexible budget rules limit expenditures |
| **Budget revenues** | High share of revenues from rent taxes on excess profits (generally, in extraction sector) | High share of personal income taxes |
| **Maturity of financial and economic system** | Low (in emerging economies, in the absence of a risk insurance and hedge system, governments are more inclined to support issuers) | High (in developed economies, state support may be considered a violation of market competition) |

Source: ACRA

## 4.4. Final credit rating assignment

The adjustment of the rated entity's SCA depends on the level of systemic importance and the state influence on such rated entity. The likelihood of extraordinary state support to a rated entity is assessed using Table 5.

[1] In accordance with the Sovereign Credit Rating Methodology according to ACRA's international scale.

[2] See point 4.2. of the Sovereign Credit Rating Methodology according to ACRA's international scale.

**Table 5. Likelihood of extraordinary state support**

| | | Systemic importance | | | |
|---|---|---|---|---|---|
| | | **Very high** | **High** | **Medium** | **Low** |
| **State influence** | **Very strong** | Extremely high | Very high | High | Moderate |
| | **Strong** | Very high | High | Moderate | Moderate |
| | **Moderate** | High | High | Moderate | Low |
| | **Weak** | Moderate | Moderate | Moderate | Low |

Source: ACRA

In order to assess the potential state support as part of this methodology, it is also necessary to determine the credit quality category of a rated entity, by comparing its SCA with the credit rating (credit estimate) of the supporting institution (see Table 6).

Category 1 is assigned to those rated entities whose SCA is equal or exceeds the supporting institution's credit rating (credit estimate). The final rating of a rated entity whose SCA is higher than the credit rating (credit estimate) of the supporting institution may be set equal to the credit rating (credit estimate) of the supporting authority, in case the analysis shows that systemic importance of, and state influence on, a rated entity may affect its creditworthiness (for example, there are risks of growing taxes, dividend payments or other forms of income appropriation by the state under unfavorable conditions; risks of socially or politically important projects, etc.).

Category 2 is assigned to those rated entities whose credit quality is comparable with the credit quality of the supporting authority. Category 3 is assigned to those rated entities whose credit quality is moderately lower than the credit quality of the supporting authority. Category 4 is assigned to those rated entities whose credit quality is lower than the credit quality of the supporting authority. Category 5 is assigned to those rated entities whose credit quality is much lower than the credit quality of the supporting authority.

**Table 6. Rated entity's credit quality category**

| | Credit rating (credit estimate) of state authority[3] | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **SCA/Rating** | **AAA** | **AA+** | **AA** | **AA-** | **A+** | **A** | **A-** | **BBB+** | **BBB** | **BBB-** | **BB+** | **BB** | **BB-** | **B+** | **B** | **B-** |
| **aaa** | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **aa+** | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **aa** | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **aa-** | 2 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **a+** | 3 | 2 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **a** | 3 | 3 | 2 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **a-** | 3 | 3 | 3 | 2 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **bbb+** | 3 | 3 | 3 | 3 | 3 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **bbb** | 3 | 3 | 3 | 3 | 3 | 3 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **bbb-** | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| **bb+** | 4 | 4 | 4 | 4 | 4 | 4 | 3 | 3 | 2 | 2 | 1 | 1 | 1 | 1 | 1 | 1 |
| **bb** | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 3 | 3 | 2 | 2 | 1 | 1 | 1 | 1 | 1 |
| **bb-** | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 3 | 3 | 2 | 2 | 1 | 1 | 1 | 1 |
| **b+** | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 3 | 3 | 2 | 2 | 1 | 1 | 1 |
| **b** | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 3 | 3 | 2 | 2 | 1 | 1 |
| **b-** | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 4 | 3 | 3 | 3 | 2 | 1 |
| **ccc+ or lower** | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 5 | 4 | 4 | 4 | 4 | 4 | 4 | 3 | 2 |

Source: ACRA

Maximum adjustment applicable to rated entity's SCA shall be determined using Table 7. The actual adjustment shall be determined by the rating committee (meeting), and it may be lower than that derived from Table 7.

**Table 7. Maximum adjustment to rated entity's SCA**

| | | | Credit quality category | | | |
|---|---|---|---|---|---|---|
| | | **1** | **2** | **3** | **4** | **5** |
| **Likelihood of support** | **Extremely high** | SCA | Parity | Parity | Parity | Parity |
| | **Very high** | SCA | Parity | Parity-1 | Parity-2 | Parity-4 |
| | **High** | SCA | Parity-1 | Parity-2 | Parity-3 | Parity-5 |
| | **Moderate** | SCA | Parity-2 (not lower than SCA) | Parity-3 (not lower than SCA) | Parity-4 (not lower than SCA) | Parity-6 |
| | **Low** | SCA | SCA | SCA | SCA | SCA |

Source: ACRA

[3] Credit estimates should be marked with the "a" prefix.

The SCA adjustment shall be determined on the basis of assessments of state’s ability and propensity to provide support (see Section 4.3). Adjustment ranges are shown in Table 8.

If the adjustment in accordance with Table 8 is more than one notch, then the final level of support used to determine the credit rating is determined within these intervals. This takes into account the expert assessment of the quality and volume of state support, the established practice of relations between the state and business in a particular country, the analysis of the historical practice of state support, the and expectations regarding its changes due to social, political, or economic factors.

**Table 8. SCA adjustment depending on state’s ability and propensity to provide support**

| | | State’s propensity to provide support is | |
|---|---|---|---|
| | | **sufficient** | **limited** |
| **State’s ability to provide support is** | **sufficient** | (Maximum SCA adjustment) x (0.5 to 1.0) | (Maximum SCA adjustment) x (0.3 to 0.7) |
| | **limited** | (Maximum SCA adjustment) x (0.4 to 0.8) | (Maximum SCA adjustment) x (0 to 0.5) |

Source: ACRA

# 5 Assessment of sub-sovereign and municipal governing authorities’ influence on the SCA

In the event of a rated entity receiving support from a sub-sovereign or municipal authority, ACRA shall take into account that the latter’s credit rating (credit estimate) acts as a constraint providing the maximum possible amount of support. In this case, a rated entity’s basic factors and systemic importance modifying factors should be assessed within the context of the supporting state government body, not within the country’s context as a whole.

The SCA shall be adjusted in line with Section 4 of this methodology.

If the SCA is deemed impossible or unreasonable, but the systemic importance of the rated entity for the regional economy is high, then, in line with Section 4 of this methodology, the Agency shall establish parity between the credit rating of the rated entity and the credit rating (credit estimate) of the sub- sovereign or municipal governing authority.

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75, Sadovnicheskaya embankment, Moscow, Russia
www.acra-ratings.com

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