



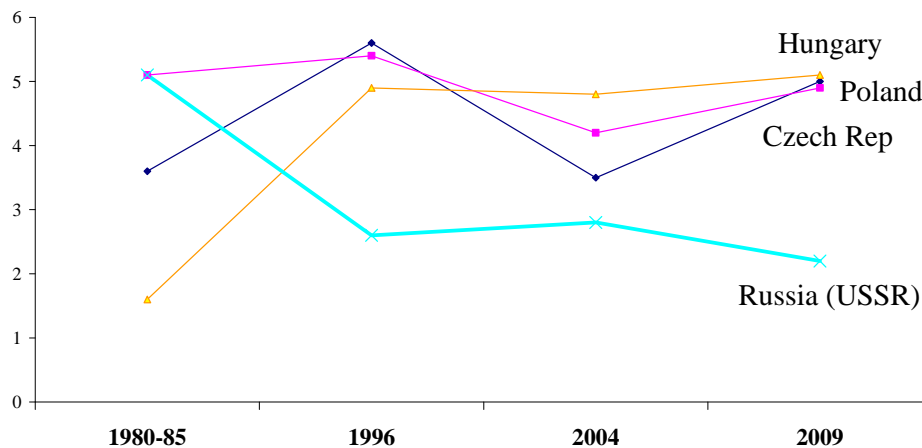
Anti-Corruption Strategies for Business in Russian Regions

Roundtable Discussion
Friday 23rd April 2010
8.30 am -10 am
UCL School of Slavonic Studies (4th Floor)
16 Taviton Street, London WC1H 0BW

Overview of corruption in Russia

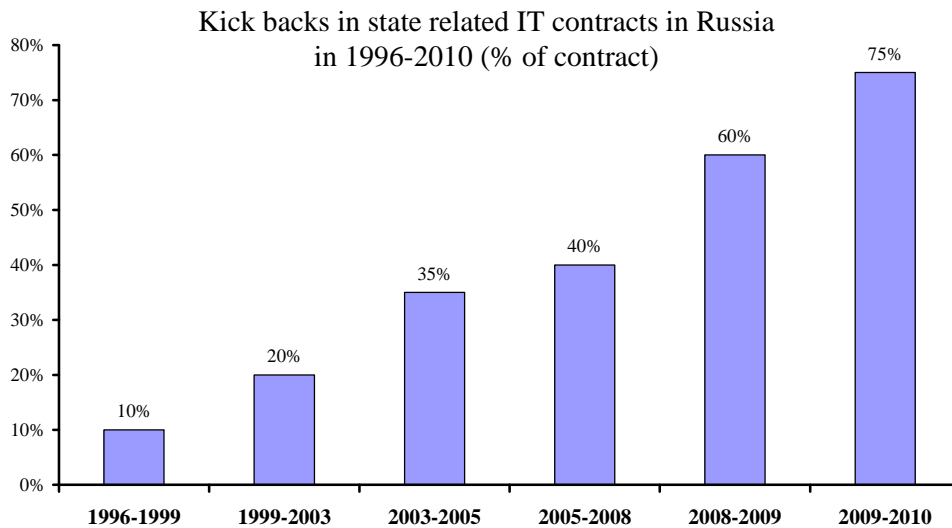
Corruption seems to be quite a serious problem all across the globe, that's why back in 1993 was found Transparency International which started to publish Corruption Perceptions Index since 1995 in order for all countries to see where they are stands in perception of corruption, compare both the dynamics of specific country and its ranking compare to the others. The last one in 2009 showed Russia on 146 out of 180 countries with the score 2.2 on a scale of 0 (highly corrupt) to 10 (highly clean). For the last 6 years plunging down from 120-x places and effectively swapping places with Nigeria which is well known for extreme corruption. The neighbors in the recent index are Kenya and Sierre Leone, Zimbabwe and Papua New Guinea. Have anybody invested there? Maybe than you could share your feelings. Interesting enough using historical data Transparency International calculated corruption indices for mid 80x.

TI Corruption Indices



Source: CORRUPTION IN RUSSIA. James Roaf, European II Department, IMF* Conference on Post-Election Strategy Moscow, April 5-7, 2000, Transparency International.

It turned out that Russia (USSR) who used to be one of the less corrupted in the former Eastern block countries became twice as bad while its neighbours achieved average level of corruption where Russia used to be 25 years ago. According to Russian business paper Vedomosti there is the following dynamics in kick backs which government officials request for the IT contracts.



Source: Vedomosti, 19.04.2010 (as estimated by Cognitive Technologies).

This gives you the practical flavor of corruption in Russia.

And we are talking about the biggest country in the world, with slightly more than 140 mln population, biggest world gas reserves, one of the biggest oil producers, world's largest forest reserves with enormous other resources including world third largest reserves of drinking water, country with relatively high level of education who gave to the world famous composers, writer, scientists and chess players. The country which experienced GDP growth from \$127.5 bln in 1998 to \$1299 bln in 2009. The country which has enormous potential and still has very deep and sound problems.

Case studies: Those who not compromise with Russian corruption become victims

Sometimes the ranking doesn't allow you to feel to ground. So let me give you couple of examples or case studies. To feel the difference I start from the companies which didn't compromise with Russian corruption and as a result became victims of Russian corruption.

1. Hermitage Capital
2. IKEA (electricity)
3. Telenor

I just took several examples which could be easily extended by both Russian and western companies in Russia (TogliattiAzot, Euroset, Slavneft, etc)

Case studies: Those who compromise with Russian corruption finally have been punished in developed world

1. Siemens;
2. Mercedes.
3. HP

Siemens

US authorities fined the German engineering group Siemens a record \$800m (£523m) to settle a long-running bribery and corruption scandal.

Siemens also agreed to pay a fine of €395m (£354m) to settle a case in Munich, its home town, over the failure of its former board to fulfill its supervisory duties. It was fined €201m there a year ago over bribery by its former telecoms division.

The US settlement, after a year of negotiations and plea bargaining, sees Siemens pay the US department of justice about \$450m (€350m) to settle charges of bribery and trying to falsify corporate books.

The Securities and Exchange Commission (SEC), the market regulator, will receive another \$350m (€270m) on similar charges under the Foreign Corrupt Practices Act. The DoJ said it was the biggest such case it had ever seen in "scope and magnitude".

According to the prosecution, the funds were used to bribe government officials and business contacts to win telecoms contracts in Russia and Nigeria.

Siemens had identified around £1.3bn in dubious payments that changed hands between 2000 and 2006.

Mercedes Benz-Daimler

[GERMAN](#) automaker Daimler pleaded guilty to US charges of global bribery and has agreed to pay US\$185 million (\$201 million) to settle the affair, the US Government said overnight. The US [Justice](#) Department said Daimler and three of its subsidiaries had resolved charges related to a Foreign Corrupt Practices Act (FCPA) investigation into the company's...

Hewlett-Packard is being scrutinized by authorities in Germany and Russia for paying bribes to win a contract to sell computers to the Russian government, according to The Wall Street Journal.

The Journal cites "people familiar with the matter" in reporting that [German prosecutors are investigating whether HP paid \\$10.9 million](#) for the chance to sell a sophisticated computer system providing secured communications to the Russian prosecutor general's office through a German subsidiary company.

HP

HP's offices in Moscow were reportedly raided Wednesday by Russian investigators looking into the matter on behalf of the German prosecutors. Specifically, they were looking for evidence that HP used a series of shell companies in a variety of countries--Britain, Austria, Switzerland, the British Virgin Islands, Belize, New Zealand, Latvia, Lithuania, and the U.S.--to create a fund that paid the Russian prosecutor's office.

So now let's try to describe how the problem looks like in order to think how to address it.

How to address corruption in Russia

So it is always the question whether you could invest in such an environment? In fact the life is much more complicated than it looks and, therefore, the answer to this question is not straight forward. Yes it is sometimes next to impossible to do business in such an environment, but what could you do if you are already in Russia, what could you do if the market there is too good to be missed, if your competitor is there and you could lose to? him this market, what if you would like to take the risk and need to know how to maneuver in this unknown sea, what if you believe that this place should finally prosper and you would like to be part of it better earlier than later even if you take extra risk, what if you are a Russian company which want to become international and doesn't want to continue bad practices even if you used to be part of it before.

If any of these true than you are in the right place to share your views, approaches and experience to help to develop your business in Russia and handle the problem of corruption.

Classification of Russian corruption:

1. Extortion.
 - a. **Regulatory extortion**, usually conducted by government officials or close to the businessman in relation to different regulatory rules in environment protection, technical standards or medical regulations;
 - b. **Profit/output extortion** could be done by local criminal groups or local government officials or local competitors or combination of above
 - c. **Intellectual rights extortions**, some criminal elements could register trademarks/websites etc under your own name and by corrupting judges/regulators or by colluding with them successfully defend their criminal acts and request money for disappearance;
 - d. **Ownership/Property extortions**. This quite sophisticated crime which has common title raiding or "raiderstvo" still doesn't have any qualification in criminal code. In fact we are talking about well established and developed criminal groups consists of businessmen and officers of law enforcement agencies who arrange illegal seizure of property with fake criminal allegations and either completely take it over or get enormous compensations for closing all the problems they arranged but usually either destroy or steal the business;

2. Business corruption.
 - a. **Sales: kick backs** to government/state owned or privately owned customers. In many occasions you could find buyers dominating markets in Russia. In this situation it is almost inevitable that the buyer will try to request either bribe or kick back for choosing your product instead of your competitor
 - b. **Inputs: Raw materials overpayment** or purchases of inferior quality supplies at a price of superior quality
 - c. **Services/outsourcing overpayments** – IT, advertisement, marketing services are the most common channel of bribes and kick backs
 - d. **Overpayment for investments/assets.** This area is one of the most dangerous because could be the most damaging for the company. In growing Russian market the investment either in new capacity or M&A activity is quite common, but since the amount of funding involved is very significant it became often area of extremely corrupt practices.
 - e. **Assets sales** from the book **at below its real value**
 - f. **Transfer pricing**, when product are being sold to intermediaries affiliated with decision maker in sales department at prices below the market price
 - g. **Hiring the relatives of management of your customer.** In fact in Russia **one of the ways to bypass straightforward corruption is employment of let's say daughter or son of your key customer where she/he doesn't do any job but this indirect kick back/bribe help to get stable consumption.**
 - h. **Basic stealing** from production unit: finished products, inputs, staples, spare parts, gasoline, etc.

Dealing with Extortion Crime

Diagnosis

The major danger of extortion attempts is the fact of involvement of law enforcement officers and other state officials. This makes it next to impossible to appeal to the other government institutions for your protection disregard to any violations of Russian law made by them. The reason is that the current Russian practice is the following: the state bureaucrats and public officers belong to the league of untouchables which makes extremely difficult to fight with them. Government/state bureaucracy is built in such manner that it is extremely offensive against any intervention form outside (ordinary people, business, society, etc) and protects its employees. It doesn't mean that those corrupt employees could never be punished or dismissed, but this could happen usually only because of internal reasons of the system, not complaints from outside. Therefore, by appealing to courts, other government agency, there are very small chances to stop such extortion effort.

Treatments

Of course, this level of corruption is by itself preventive measure for any investments. Indeed, for the last years there have been many investors both domestic and foreign who left Russia. But the discussion on how Russia end up with such corruption, how much damage it brought to the country and what could be done to change the situation is a matter of separate discussion. Today we will concentrate on what could be done by investors who even knowing the situation decided to invest in Russia, not only in its capital Moscow but also in the regions.

1. Firstly, it is very important to be aware of these extortion risks. *Praemonitus praemunitus*- Forewarned is forearmed. By knowing the problem you should be ready from the very beginning to delegate your time, resources and energy to this problem.
2. You must be **legally equipped** (you should have lawyers experienced in Russian raiding practice). These lawyers should make sure that you are complying with the local legislation, but also make pre-emptive protection measures so that property rights, contracts and agreements are properly registered, well thought, backed up and also physically secured.
3. You should **build your relationship** with local governor and have regular interactions. It is extremely important to show from very beginning that you are not ready for any corrupt co-operation. But you are ready for economic cooperation. You should explain how important what you are doing is for the region (employment, new technologies, management expertise, etc.), ask how you might be helpful with social budget. It is important to make such social investment that would be both helpful for region and will be well recognised by local authorities and public opinion.
4. You should **take care of your image in the region** both in media and in the eyes of local authorities. Although the freedom of the press is limited, still there is public opinion and it is important to be treated as valuable citizen of the region.
5. It is highly recommended to **have a social budget**, so you always has moral ground to say that you not only earning your profit in the region but also spend some of it for the regional well being. It both good for PR prospective, and to raise people recognition of your company and sometimes make local authorities at least interested in you as one of minor but stable donor.
6. Rare but regular **visits of your company highly ranked executives**, who could have meetings with governor, key local authorities and members of local business community, supports your image and importance and help to establish connections which could be helpful in the worse case scenarios.

The above remedies of cause will not protect you from the extortion attempts, although if the above strategy is well thought and properly implemented, the significant amount of potential extortion attacked could be excluded simple because for those who are doing it, there are plenty of easier targets. Secondly, if anyway the extortion will happen, by being properly legally armed, having allies in governor office and in local business community you have much better chances of protecting your investments than otherwise.

Dealing with Business corruption

Diagnosis

For the second type of corruption the key element is the internal management/employee corruption. Although there are some outsiders involved as well, without the insider knowledge this corruption would not be possible. Russian practice shows that business or corporate corruption is enormously wide spread regardless of geographical location, industry or size of the business.

Treatments

On one hand there are well known “medicine” against corporate corruption (accountability, control, code of ethics, etc.) which could be applied here, on the other hand it is extremely important to keep in mind Russian specifics.

1. First of all it is important to understand that the problem of business corruption is unavoidable in Russia and maybe the mentality of Russian people will change in the future but it could take generations and no investor who wants to invest in Russia today could neglect it. Again: Forewarned is forearmed.
2. **Accountability.** Modern IT system which controls flows of money, inputs and outputs being fully implemented via necessary training and testing could significantly decrease opportunities for business corruption.
3. **Control.** It is important permanently to control that flows of money and goods and analyze them in order to identify potential areas of corruption. This activity could be delegated to internal control department who should be subordinate directly to CEO in order to be independent from other employees.
4. Implementing different **intra-company regulations**, which are used as a guide book for most bribery areas: choosing the raw materials suppliers, outsourcing, IT and marketing expenditures and sales. These regulations quite often are playing unique role. On the one hand by implementing clear and thoughtful procedure you already narrow the potential field for corruption. On the other you provide yet another reason to the managers of your company to explain to outsiders why bribery is not possible. It is important to revise them from time to time, so they reflect the new trend in potential corruption risks
5. **Transparency.** It is quite important management tool. The intracompany transparency makes it more and more difficult to protect corrupt practices.
6. **Corporate values and ethics.** It is important to understand that executives are playing key role in fight against corruption because their behavior establishes the example or pattern for company’s employees. If you are able to find those ones who are indeed honest and loyal to your company, then you could implement corporate values and even produce code of ethics, which your managers and employees should follow. The major issue is not to make it but **monitor** its implementation regularly, have the ability for employees to complain if it doesn’t work and regularly evaluate and amend it if necessary.
7. Regional investments give you unique instrument which being used wisely could bring amazing result. We are talking about **references to the Main office.** “We understand Russian practice and would be happy to help, but MAIN OFFICE. They implemented SUCH PROCEDURE which is impossible to break. They implemented SUCH IT system, which could see everything. We even asked them is it possible to give at least small bribe, and they replied NEVER, not because they don’t want to help, but because they afraid to death to follow the fate of Siemens, Mercedes or HP.” All these hypothetical examples show you how wide could be the reference to the Main office. But this magic reference could save your investments from many problems in Russia.
8. New initiatives in Russia: when sound western business sign voluntarily agreement with other members of business community **not to give or take bribes.** This symbolic action also could be successfully used afterwards as a reason why you can’t give bribes.

Conclusions:

Corruption in Russia plays absolutely different role than in any developed countries. In developed countries existing corruption is opposed by established economic and political institutions: laws, law enforcement agencies, independent court system, free public media, political party diversity, national moral leaders. In some countries one institution is weaker in the other, but usually weakness of one institution is supported by strength of the others. In Russia we have unique situation when neither of these institutions works. Laws are consistently violated and neglected by those who suppose to enforce them. Those who are supposed to enforce laws in fact enforce crime, fully ignoring laws. Courts who are supposed to make independent judgments are trying to beat 100% probability in issuing results requested by law enforcement agencies, etc. As a result corruption in Russia became an institution itself. The institution which links the local and federal level of authorities that glue economic relationship between the state and the society, which eventually fuel existing economic and political system which in many cases even recognized as corruption because people so much get used to it. Therefore, if you decide to invest in Russia you will inevitably face corruption and will need to answer to yourself what you are going to do with it.

Final remarks:

Today Russia is all in dark clouds of corruption. Despite the fact that we discussed today of how to diminish the consequences of this decease, we should never forget about the fact that today's corruption in Russia is probably the biggest danger for not only development of Russia, but Russia as a state. We all here who discuss this problem today should never be afraid of pointing out it publicly that corruption should be fought in Russia, because by closing the eyes on what is happening we are doing bad for Russia and finally for our investments there. But real fight with corruption (not a lip faith) is possible only by addressing the most sound corruption cases, by publicly punishing people responsible for it. In this respect there is no more sound, outrageous and devastating case than the case of Hermitage Capital. This is not only the case on how the business in Russia of biggest foreign portfolio investor was destroyed, it is the story of criminal corrupt group who during the 4 years have stolen from Russian state, all Russian people more than 400 mln dollars, it is the story about hero of our time – Sergey Magnitsky who was not afraid to speak up about this corruption, but who was illegally arrested, seized in prison and tortured to death at the age of 37 years. Until this crime is not punished the corruption in Russia will be synonym of impunity

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