

October 15, 1999

## Russia: The Cancer of Corruption

**Widespread reforms, solid security practices required to thwart organized crime in Russia**

*Each passing day brings disturbing new developments as authorities delve into the largest money-laundering scandal ever seen by Interpol, the international law-enforcement agency. U.S. investigators believe that up to \$15 billion from Russia may have passed through as many as 10 American banks, with individual transfers as high as \$200 million. Although the massive dollar amounts involved suggest multiple sources, investigators suspect that part of the funds originated from the organized crime element that holds Russia in its thrall. While corruption in Russia is hardly a new development, the recent allegations further undermine the nation's efforts to entice overseas investors—a historic problem that has contributed to Russia's deplorable economic state.*

*Lack of foreign investment, however, represents a relatively minor consequence of Russian organized crime in comparison to the issue of capital flight, which drains an estimated \$15 billion each year from the Russian economy. Experts attribute at least 40 percent of this capital flight to organized crime groups. The iron grip these organizations have on the Russian government sabotages financial relief efforts at the expense of the nation's citizens. Of the \$110 billion that Western countries and financial institutions loaned to Russia between 1991 and mid-1998, approximately 40 percent returned to the West in bank accounts controlled by criminal organizations.*

*This issue of The Lipman Report examines the intricacies that bind the Russian government with its organized crime groups, the consequences of that alliance, and the steps being taken to liberate the nation from its criminal element. This edition also offers suggestions to help international companies guard their assets against the taint of Russian corruption.*

### **A Time-Honored Tradition**

Corruption has long been a way of life for residents of the former Soviet Union. At the turn of the century, Vladimir Ilyich Lenin, the father of Communist Russia and the first premier of the Union of Soviet Socialist Republics, transformed Russian organized crime from common thieves and criminals to allies in financing the newly formed Communist Party. In 1905, for example, Lenin coordinated—and his successor, Joseph Stalin, supervised—an armed hold-up in Tiflis, as Tblisi was then called. Stalin continued such

alliances with the underworld, employing mobsters to enforce his authority and to help subvert Western economies through mass-production of counterfeit money. During Stalin's rule as premier, gangsters were described as "socially close" to distinguish them from free-thinking political enemies who threatened the regime.

The marriage between the Communist party and Russian organized crime continued throughout the Soviet era, providing the latter with rich opportunities when the union collapsed. The necessary transition from a command economy to a market economy took place in the absence of a legal infrastructure, with the government transferring control of state-owned business enterprises to friends or supporters of the administration, who in turn expressed their appreciation through financial support and positive media coverage. This manner of privatization enabled organized crime to gain a significant presence in the legitimate economy of Russia, allowing them to infiltrate high levels of power across the system.

Further compounding the situation, Russia does not benefit from the illicit activities of its criminal empire, unlike other nations with powerful organized crime groups. An assessment of the drug-trafficking industry in Colombia, for instance, concludes that a majority of the profits remain within the domestic economy. Russian gangsters, on the other hand, prefer to direct their profits abroad, establishing offshore shelters, investing in foreign economies—in short, demonstrating the same lack of confidence in the Russian economy as the rest of the world.

As a result of widespread capital flight, two-thirds of Russian citizens live below poverty level, while the wealthiest five to 10 percent of society amass great fortunes. In a 1996 meeting with representatives of the Federal Bureau of Investigation (FBI) and the Central Intelligence Agency (CIA), the U.S. House of Representatives Foreign Affairs Committee discussed the assets of then-Prime

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Minister Viktor Chernomyrdin. The Russian official's fortune increased from \$28 million to \$5 billion in four years at a time when the nation could not afford to repay its debts.

### Not an Isolated Incident

Recent allegations of Russian money laundering merely represent a more sensational example of the crimes routinely committed in a nation rife with corruption. In the current investigation, the FBI has uncovered transactions that involve close associates of Russian President Boris Yeltsin. Formal implication of Russian officials would only confirm continued adherence to the practices that have permeated the nation since the dissolution of the Soviet Union, when those in power turned over state-controlled assets to friends and relatives—often for immediate liquidation.

Working with reliable contacts in the Russian Ministry of the Interior (MVD), for instance, the FBI uncovered an elaborate scheme that was systematically emptying the national treasury of the Russian Federation. A long-time associate of Yeltsin and former head of the Russian State Treasury became chairman of the Committee on Precious Metals and Gems, despite numerous allegations of misconduct in his previous office. He persuaded the state budget director to put up half a billion dollars of goods from the State Treasury as collateral to finance a state-of-the-art diamond center called Golden ADA. By the time the U.S. Internal Revenue Service (IRS) shut down Golden ADA's operations in San Francisco, the company had sapped \$178 million in riches from the Russian treasury. Even worse, Golden ADA represented only one of a series of scams with total losses exceeding \$1 billion.

In another incident, the Russian Accounting Chamber is attempting to prosecute a former Deputy Finance Minister suspected of abusing his position and embezzling budgetary loans. In

1995, an associate of Yeltsin received more than \$7 billion from the state budget, accompanied by customs privileges from the Ministry of Finance. As President of the National Sports Foundation, this citizen imported not only sporting goods, but also millions of dollars in tobacco and alcohol products duty-free. These privileges made the National Sports Foundation Russia's leading liquor importer, netting millions of dollars in profits. Given the present state of the Russian government, prosecution in the case will not come to pass. The Prosecutor General's office generally ignores appeals from the Accounting Chamber, granting Russian officials immunity from charges such as tax evasion, fraud, theft and embezzlement.

Indeed, the new Russian culture does not treat kindly those society members who would take the high road. Bankers and journalists who counter the prevailing system often find themselves the targets of professional assassins. The low pay and high risk associated with Russian law enforcement convince many police officers to freelance for the criminal element, supplementing their meager income and prolonging their life expectancy.

### 'A Global Threat'

Following the Russian financial crisis of 1998, the sheer magnitude of the money-laundering investigation suggests to world leaders that the time has come to remove the influence of the criminal element. In his recent testimony before the House Banking Committee, U.S. Secretary of the Treasury Lawrence H. Summers said, "Russian organized crime has emerged as a powerful corrupting force—a force that challenges Russia's political and economic development. It has also become a global threat, one that poses a challenge to our financial system."

Law-enforcement officials have only started issuing indictments in the Bank of New York investigation, and future developments could hold far-reaching consequences for the other financial institutions involved. At least one bank

executive has admitted that some of the institution's employees exercised poor judgment by failing to notify regulators of suspicious activity in the Russian accounts. "In hindsight, Russia proved to be such a gold mine for Western investors and banks that many of these companies started doing business with the Russian firms and banks without investigating their partners," said an East-Coast representative for another international financial institution. "It is a problem that is endemic in any company. We are all under pressure to produce; therefore, some managers will take shortcuts."

Such shortcuts could prove increasingly risky for companies as the influence of Russian organized crime continues to grow. Officials of the Organized Crime Control Department of the MVD report the existence of more than 8,000 criminal groups from Russia, Eastern Europe and Eurasia, and more than 150 ethnic-oriented criminal groups. Among the latter, 25 such organizations conduct activities in the United States. Furthermore, according to FBI Director Louis J. Freeh, the organized crime groups from this part of the world gravitate to sophisticated criminal activities, such as computer crime, health care industry frauds, and bankruptcy and insurance frauds. The tendency to pursue more complex criminal activities, combined with their penchant for violence, contributes to these groups' increasing power in the United States.

### **Fighting Back**

In 1998, a Berlin-based anti-corruption organization ranked Russia as one of the 10 worst countries in which to conduct business. The world cannot, however, turn its back on this former superpower, the financial health of which plays a major factor in the stability of the global economy.

To help combat the corruption that has diverted much of the financial aid provided to Russia during the last decade, the United States has recommended placing specific conditions on such international relief loans. These conditions include

the implementation of tax systems designed to decrease bribery and tax evasion by large, well-connected companies; the removal of price controls to eliminate corrupt distribution systems and decrease insider arbitrage opportunities, which enable traders to purchase commodities cheaply for guaranteed resale at higher prices; and the creation of a Russian treasury and budgetary control system to reduce skimming and other dishonest acts. Such measures will help ensure that relief funds reach their intended destinations.

Another important step in fighting the organized crime element in Russia involves restructuring the salary scales for public servants, while implementing a policy of public disclosure. The current system allows bureaucrats to collect illegal income and bribes with impunity. In addition, the meager wages paid to law enforcement personnel encourage them to maintain, rather than fight, the prevailing corruption by seeking similar kickbacks to supplement their sub-poverty income.

The necessary changes demand reform within the Russian government and support from other developed nations, and they cannot occur overnight. In the meantime, international organizations can pursue the rich investment opportunities in Russia by following basic security precautions.

- *Establish close relations with the embassy.* The embassy can serve as an invaluable ally in helping companies investigate potential business partners and gain an understanding of the political, social and cultural climates of the region. "The best thing for any corporation considering business in Russia is to do the homework and involve its home embassy as much as possible," said a former FBI official. "The embassy can offer assistance, for instance, in determining the legality of a contemplated venture." Another source of assistance, the FBI has legal attachés in the Russian embassy who work with the local authorities to investigate individuals who may be embroiled in corruption.

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- *Perform background checks of corporate partners and prospective employees.* The U.S. Department of Commerce can provide organizations with a comprehensive look at a country's commercial environment, including economic, political and market analysis. In addition, companies can request an International Company Profile (ICP) from the Department of Commerce. These investigations can yield the following information: bank and trade references; principals, key officers and managers; reputation; recent news items about the firms; and activities of prominent owners.

Just as in the United States, background investigations on prospective employees play a critical role in sound security and should include the following: verification of work history, educational institutions and degrees earned, and professional and personal references. According to a former manager of the FBI's Organized Crime Program, background investigations are still rare in Russia, encouraging the common practice of inflating professional and educational achievements. "You need to make sure that you really identify whom you're dealing with," he said. "You're not going to find out everything, but you need to make sure you go back and keep rechecking." Verifying the veracity of references is an especially important step.

- *Employ a carefully screened security partner to provide on-site security.* The corruption that plagues Russian law enforcement also pervades the private security industry, making the selection of a partner a risky, but vital, decision. A professional security organization can provide invaluable consulting to establish a comprehensive security program—ranging from physical protection, such as access control and uniformed security personnel, to policies and procedures to guard against terrorism, theft and white-collar crime. Such a partner can also ensure that security incidents gain

an audience with the appropriate authorities. Companies that suspect criminal activities should contact the FBI for additional guidance.

Even companies that operate solely in the United States should not ignore these security measures. Some of the criminal elements in Russia have started operations in the United States and are, in some cases, filling the voids left by successful prosecution of American organized crime. In addition, the globalization of world economies places virtually all businesses at risk through the international connections of their corporate partners.

*With an abundance of natural resources and investment opportunities, Russia remains an important global player, but one that, for now, must be dealt with carefully. Criminal groups control approximately 41,000 businesses in Russia, half of the financial institutions and 80 percent of the joint ventures. To fight this problem, the United States must work with other nations to provide an example for the Russian government to follow in establishing a controlled, ethical business environment, one regulated by a judicial system that will enforce laws strictly and impartially. Only such widespread reform can help end the corruption that has decimated the former Soviet Union during the last decade.*

*Recent U.S. Congressional hearings on Russian money laundering, chaired by Representative James A. Leach, R-Iowa, underscore the critical responsibility of financial institutions to exercise due diligence in identifying their customers—a lesson that all businesses should heed. Unless organizations take careful measures to investigate their partners, their employees and their security practices, they could find themselves the next victim of the Russian crime wave. The subsequent hearings scheduled this fall should yield additional insights into Russian criminal activities.*



The Lipman Report Editors