

# **EXHIBIT 18**

**MINISTRY OF THE RUSSIAN FEDERATION**

**FOR ANTIMONOPOLY POLICY  
AND SUPPORT TO ENTREPRENEURSHIP**

**ANNUAL REPORT ON COMPETITION POLICY DEVELOPMENTS**

**IN THE RUSSIAN FEDERATION IN 1999**

**Introduction**

1. In 1999 activity of MAP Russia and its Regional Offices aimed at enhancing the effectiveness of state antimonopoly regulation, fostering competitive environment, supporting entrepreneurship, overcoming regional separatism, strengthening state regulation of natural monopolies as well as state control of the observance of antimonopoly legislation, and advertising consumers' rights protection legislation. To accomplish these tasks in the administrative units of the RF, 70 Regional Offices were established within the organisational structure of MAP Russia; thirteen of them fulfilling their functions in two or more administrative units of the Russian Federation.

2. In 1999 market reforms proceeded in conditions of revival of production and trade in some of the economic sectors against the backdrop of a weakening Ruble and growing world oil prices. Among positive elements of 1999 we can mention nearly the double increase in foreign trade balance, relatively low annual inflation, and the start of economic restructuring in favour of manufacturing industries. At the same time the investment capacity of many enterprises and the purchasing power of large segments of population still remain limited, which tends to hold up the development of competition in the economy. Simultaneously, large-scale processes of economic concentration are in place, in many cases of a concealed character, through complex interrelationships between economic entities. The year 1999 saw the strengthening recurrence of monopolistic price policy in metallurgy, oil refining and some commodity sectors. These developments introduce significant changes into the state antimonopoly policy, activity in support of business and regulation of sphere of natural monopolies.

3. Effective accomplishment of functions vested in MAP Russia is linked directly with the appropriate legal background. The legal framework regulating the competitive relations in real and financial sectors of economy, protection of consumers' rights and advertising activities includes:

- in the field of state policy of fostering competitiveness and commodities markets, as well as prevention, limitation and suppression of monopolistic activity and unfair competition – RF Law “On competition and limitation of monopolistic activity on commodity markets” (adopted in 1991, amended in 1995 and 1998);
- in the field of state regulation and control of activities of natural monopolies in the fields of communication and transport - the federal Act "On natural monopolies " (adopted in 1995);
- in the field of antimonopoly control over financial markets, as well as over futures and optional contracts on the stock market - the Federal Act "On protection of competition on the financial services market" (adopted in 1999);
- in the field of state support of small & medium size enterprises - the Federal Law "On state support of small business in Russian Federation " (adopted in 1995);

## RUSSIAN FEDERATION

- in the field of regulation of establishment and operation of commodity exchanges, exchange trade and legal guarantees for activity on commodity exchanges - the RF Law "On commodity exchanges and exchange trade" (adopted in 1992, amended in 1993, 1995);
- in the field of regulation of relations arising during production, location and dissemination of advertising in the product markets, works and services of Russian Federation - the Federal Act "On advertising" (adopted in 1995);
- in the field of protection of consumers' rights – RF Law "On protection of consumers' rights" (adopted in 1992, amended in 1996, 1999).

4. The Report contains an overview of the basic changes in Russia's Competition law, information on the practical implementation of antimonopoly legislation, examples of cases considered by antimonopoly authorities involving the most typical and widespread violations of antimonopoly legislation as well as the future activity perspectives of antimonopoly authorities.

### **I. Changes in competition policy**

#### ***1. Changing the competition legislation***

5. In 1999 subsequent amendments to the legislative framework providing the basis for the conduct of state competition and entrepreneurial policy were introduced as an important element of the adequate transformation of this policy. In December 1999 the Federal Act "On amendments to article 18 of the RF Law "On competition and limitation of monopolistic activity on product markets" was adopted. The article 18 of the RF Law "On competition and limitation of monopolistic activity on product markets" provides for state control over observance of antimonopoly legislation in course of acquisition of stocks (shares) in the original capital of commercial organisations and other cases. The accepted amendments aim at strengthening antimonopoly control over mergers and acquisitions and secure the provision of antimonopoly authorities with information about sources, conditions of acquirement and volume of resources necessary for such transactions. The amendments provide moreover for the deadlines to be met by antimonopoly authorities in the review of transaction (1 year). The amendment to Article 18 of the Law "On competition..." aims at preventing illegal economic concentration through fictitious persons, including through offshore companies.

6. One ought to take a special note of the adoption of the Federal Act "On protection of competition on the financial services market" of 23.06.99 No. 117-FZ. The law provides for principles, norms and procedures of antimonopoly regulation in banking and insurance spheres as well as on securities markets, and substantially widens the possibilities of antimonopoly control of the financial markets. The law establishes legal norms, the application of which enables the antimonopoly authorities to determine the possible anti-competitive consequences of transactions. It foresees the control of horizontal, vertical or other links of all participants to the transaction and, on this basis, adopting decisions against ungrounded economic concentration on the market of financial services. In course of implementation of the Federal Law "On protection of competition on the financial services market" on 07.03.2000 the RF Government adopted the Decision No. 194 "On conditions of antimonopoly control over financial services market and approval of methodology for determining the turnover and borderlines of financial services rendered by financial organisations". Several other methodological documents and recommendations were also issued.

7. New normative legal acts were adopted, having a direct relationship to the accomplishment of entrepreneurial policy. These include:

8. The Federal Program of state support of small business of the Russian Federation for 2000-2001 (adopted by the RF Duma in April 2000). The Program aims at normative legal support of small & medium size enterprises, development of progressive financial technologies of support of SMEs, implementation of priority development areas of SMEs. That includes creation of jobs and support of import substituting production, enhanced effectiveness of use of the created infrastructure of support of SMEs and information systems, scientific-methodological and human resources back-up of SMEs, interaction with mass media and propaganda of entrepreneurial activity.

9. The decree of RF Government of 31.12.99 No. 460 "On the complex of measures on development and state support of small enterprises in the sphere of material production and assistance to innovation activity ". The decree determines the priority branches.

10. The careful consideration of MAP Russia was also given to the improvement of normative legal framework of state regulation of natural monopolies in the fields of communication and transport (decrees of Government of Russian Federation, departmental normative acts).

## **2. *Other relevant measures***

11. MAP Russia ensures active interaction with judicial authorities, including prosecutor's office and courts dealing with violations of the antimonopoly legislation, with executive and legislative authorities of the administrative units of the Russian Federation and local administrations. A report was prepared on operation of MAP Russia identifying facts of illicit interference of state authorities and their officials in economic activity of enterprises. The report was presented to the Ministry of Justice of the Russian Federation for the RF Government information. Recommendations were prepared and forwarded to territorial antimonopoly authorities on implementation of consumers' rights protection competence in courts of general jurisdiction. According to the decree of the RF Government of 19.07.99 No. 829 "On the declaration of the R.F. Government and Central Bank of Russia on the policy of development for the purposes of the third loan on structural modification of economy and planed measures of their implementation", a Report was prepared and submitted to the Government of the Russian Federation "On economic policy measures aimed at decreasing anti-competitive horizontal and vertical integration and integration on the key markets of specific goods and geographical markets in industry and in the infrastructural monopolies sector".

12. The RF Government decree "On approval of the status of the RF Ministry for antimonopoly policy and support of entrepreneurship" was adopted on 12.07.99 No. 793 determining the tasks and functions of the Ministry, its rights and also the rights of the Minister, organisation of activities of the managing collegiate bodies, and organisational questions of the Ministry activity.

## **3. *Legislative changes proposals of the RF Government***

13. A number of draft laws for the purposes of improving the legal framework for the accomplishment of the antimonopoly policy, state regulation of natural monopolies in transport and communications, support of business, conduct of state consumer policy and control over advertising activity is being currently elaborated by MAP Russia acting in concert with appropriate federal executive authorities. In particular, the following draft laws are being prepared for submission to the Government (or have been already passed to the State Duma):

- the draft Federal Law "On amendments to the Law of Russian Federation "On competition and limitation of monopolistic activity on goods markets" (provides for improvement of

## RUSSIAN FEDERATION

monopolistic prices and anti-competitive agreements revealing procedure, reinforcement of measures against abuse of antimonopoly law as well as increased responsibility for violation of antimonopoly legislation);

- the draft Federal Law "On amendments to the Law of Russian Federation "On commodity exchanges and exchange trade " (provides for vesting in the RF Government the rights to determine the list, the share and exchanges authorised to trade in strategic kinds of production vital for the economic security of the country (through the system of exchange trade);
- the draft Federal Law on "Exchanges and exchange activity" (changes the approach to the state regulation of exchange activities, clarifies the licensing rules for exchange activity, defines the list and share of obligatory realisation through the exchange of some types of strategic goods (oil and oil products, ferrous and non-ferrous metals, grain and grain products, timber, sugar, etc.);
- the draft Federal Law "On amendments to the Federal Law "On advertising" (the amendments aim at increased efficiency of State control on advertising activity);
- the draft Federal Law "On amendments to the Federal Law "On State support of small business in the Russian Federation" (the draft aims at clarification of definition parameters of a SME, completion of the rules of state aids for SMEs, and improvement of interactions within the state aids system for small business);
- the draft Federal Law "On amendments to the Federal Law "On natural monopolies" (provides for extension and clarification of the fields of the Law application, clarification of the concept of natural monopoly, introduction of rules regulating local natural monopolies, and extension of methods of price regulation on different natural monopolies);
- conclusions have already been prepared for the draft Federal Laws "On amendments to the Federal Law "On federal railway transport", "On seaports of the Russian Federation", "On direct mixed (combined) transportation", aiming at improving the regulation of economic activity of natural monopolies.

## II. Implementation of competition policy

### 1. *Actions aimed at suppression of anti-competitive practices, including abuse of dominant position and collusion*

14. Violations stemming from abuse of dominant position are the most widespread phenomena on the Russian markets, amounting - in 1999 - to 46 per cent of the total number of applications considered (in 1998 - 42 per cent). In 1999 prevention and suppression of cases of monopolistic activity of economic entities was considerably extended. The central office of MAP Russia and its regional offices considered about 2100 cases (both on the basis of the complaints and on their own authority), involving violations of article 5 of the Federal Law "On competition..." (abuse of dominant position) The violations were confirmed in 1026 cases. Out of these, 48 per cent of violations were settled by mutual agreement, and in 538 cases (52 per cent) the legal proceedings were initiated.

15. Most of the complaints on abuse of dominant position have still concerned the following markets: electricity and heat energy, gas, oil and petroleum, communication, railway transport, air transport and airports. Among cases reviewed under article 5 of the Law "On competition..." there was 47per cent

increase (over 1998) in the number of complaints concerning withdrawal of the goods from the market to create a shortage and 58 per cent increase in the number of violations of the established pricing criteria.

16. Samara Regional Office of MAP Russia has considered a case on infringement of Article 5 of the Law "On competition..." by a municipal enterprise of water supply and sewerage disposal of the town of Syzran (hereinafter - Enterprise), which obligated its customers - physical persons - to install the water meters and indicated the place of the purchase of the meters - only in the "Leader" shop. Such actions of the dominant economic entity infringed the interests of citizens, and also restricted competition on the retail market of water meters of Syzran. The practices constituted violations of Article 5 of the Law "On competition..." The Enterprise was instructed to relinquish the practices of demanding the obligatory installation of water meters and purchasing them in the specified shop. The instruction was complied with.

17. In September 1999 the Stavropol Regional office of MAP Russia, referring to violation of paragraph 1 of Article 5 of the Law "On competition...", instituted the legal proceeding against "Ipatov Meat and Chicken Plant" Company for applying monopolistic prices, violation of legal pricing rules regime and imposing unfavourable contract conditions. The "Ipatov" Company owns a 455 m long railway access, which is used by other five economic entities. Since July, 1999 the Company significantly increased the rail tariffs per car. Analysis of the financial documents has shown that the tariff costs calculations were exaggerated. After being instructed to terminate the violation of antimonopoly legislation, the Company reconsidered the per car tariffs in accordance with the pricing rules regime in this branch. Now the tariff is 450 roubles, which is only half the original price.

18. During the period at issue, much attention was given to stabilising the state of affairs on the market of oil and oil products in the Russian Federation and curbing the rise in prices for the goods in question. Violations of antimonopoly legislation were identified in some of the RF administrative units and appropriate measures were taken to halt the infringements (at the same time, identified and terminated were the violations of legislation on the consumers' rights protection, and tax and licensing legislation in some of the RF administrative units). The completion of comprehensive controls of the oil products markets was significantly complicated by the limited human resources of the antimonopoly authorities as well as the lack of a system protecting the staff from illegal actions and criminal infringements.

19. Not all the cases of oil price increases by the economic entities can be considered as violations of antimonopoly legislation. The necessary prerequisites for such a consideration are: a) a dominant position on the relevant market of the economic entity increasing the price or b) or a significant share on the relevant market obtained by the parties to the setting (maintaining) prices agreement. The results of the oil price verification demonstrated that at issue in many cases are the possible anti-competitive price collusion practices.

20. The legal practice under Article 6 (competition restricting agreements) of the Law "On competition..." has extended (120 per cent by 1998) though the number of the reviewed competition restricting agreements cases is still insignificant. In 1999, 69 cases were examined under Article 6 of the Law "On competition". Violations were confirmed in 49 cases, in 41 cases legal proceedings were instituted. 26 decisions were undertaken, and in 15 cases the proceeding was terminated.

21. Under Article 6, a growth in the number of cases of illegal setting (maintenance) of prices (tariffs), discounts, refusals to deal with certain consumers, and illegal agreements of non-competing economic entities can be observed. Serious problems arise in course of collection of monopolistic activity evidence, especially in cases of concealed anti-competitive agreements, since this requires operational-investigation activities, which do not fall within the competence of MAP Russia. To reach effective application of Article 6 of the Law "On competition..." in 1999 regional offices of MAP Russia conducted

## RUSSIAN FEDERATION

controls of activities of economic entities with respect to anti-competitive agreements and collusions. 200 controls were conducted, and 34 legal proceedings were initiated as a result.

22. South-Siberian regional office of MAP Russia instituted the legal proceeding under Article 6 of the Law "On competition..." for a simultaneous price increase on the market of retail trade of oil products in Krasnoyarsk in May, 1999 by 76 owners of gas stations. On 01.06.99 in Krasnoyarsk territory the surcharge to the wholesale price for AI92 gasoline exceeded 100 per cent and to the price of •I80 gasoline - 90 per cent. In June a simultaneous rise of retail prices in all gas stations took place. The simultaneous price rise in all Krasnoyarsk gas stations allows qualifying the operations of the gas stations owners as monopolistic collusion aiming at establishment and maintenance of uniform prices with the purpose of gaining excessive profits. In course of the proceeding the fact of violation of paragraph 1 of Article 6 of the Law "On competition" was confirmed. The commission established that 25 economic entities competing on the market of retail sales of petroleum in Krasnoyarsk and having a 35 per cent aggregate share of retail sales of gasoline •I-76, 80, •I-92, 93 acted aiming at establishment and maintenance of high prices for the said gasoline marks.

23. The fact of co-ordinated activities in establishment and maintenance of the prices can be confirmed by the simultaneous increase (establishment) of prices and maintenance of their level during the time period in question; increase of prices to the certain level by all market participants; lack of economic substantiation for the price rise. The commission issued the instruction to transfer into the income of the federal budget the profit resulting from violation of antimonopoly legislation. Three economic entities appealed the said decision to the arbitration tribunal, and in two of these cases the decision of the territorial office was sustained. With regard to the third entity the tribunal satisfied the claim qualifying its activity as wholesale marketing of fuel and lubricants while the question of consideration was retail trade. Five economic agents complied with the instruction and transferred the profit obtained by violation of antimonopoly legislation to the federal budget income.

24. Novosibirsk regional office of MAP Russia received a complaint from a commercial organisation concerning the anti-competitive agreement inside Novosibirsk association of realty companies (hereinafter Association). The co-ordination (harmonisation) of commercial activity proceeded in two directions: co-ordination of price policy and co-ordination of advertising activity. Having considered materials of the case the commission of Novosibirsk regional office of MAP Russia decided to issue the instruction to relinquish the violation of Article 6 of the Law "On competition...". The essence of the violation consisted in co-ordination of commercial activity resulting in restriction of competition; carrying out of the agreed price policy; prohibition to publish the information about costs of services and offered discounts.

25. The Association appealed to the arbitrage court claiming for the waiving of the decision and instruction of the commission. The lower court annulled the decision of the commission of Novosibirsk regional office, having considered that the presented evidence was insufficient to confirm the restriction of competition and collusion between the members of Association concerning establishment of a certain price level. The arbitrage court of appeals annulled however the decision of the lower court, recognising as justified the arguments of Novosibirsk regional office of MAP Russia that the Association co-ordinated the commercial activity of its members by two means - price fixing and advertising activity. The arbitrage court of the first instance indicated that Novosibirsk regional office of MAP Russia did not prove that such co-ordination has entailed restriction of competition. However such reason was not taken into consideration by the court of appeal because Article 6 of the Law "On competition..." prohibits associations to co-ordinate their commercial activity which can result in restriction of competition. The described case shows the difficulties in proving the existence of the price fixing agreements. Due to the fact that it was practically impossible to obtain direct evidence of the existence of a restrictive agreement, in this case one had to rely on indirect evidence.

**2. State control over reorganisation of commercial organisations and their associations, observance of the antimonopoly legislation at purchase of shares in the original capital of commercial organisations**

26. In 1999 the volume of operations concerning the control of economic concentration (Articles 17, 18 of the Law "On competition...") increased considerably.

27. During the period of 1999 the antimonopoly authorities considered 10250 applications and notifications on the basis of Article 17 (control over establishment, merger, reorganisation and liquidation of economic entities) and Article 18 (State control over acquisition of stocks, shares) of the Law "On competition...". Concerning Article 17 the number of considered applications and notifications constituted 118 per cent of a level of 1998. Compared with 1998, the number of considered applications and notifications concerning acquisitions of stocks (shares) and other cases (article 18) increased in 1999 by 66 per cent. Total amount of these operations has grown both in the central office of MAP Russia and its regional offices. Despite of the financial crisis the participation of foreign investors in acquisition of stocks (shares) in the original capital of Russian enterprises has increased. The number of applications and notifications with the participation of foreign investors has increased more than by one third. The practice of settling the applications under Article 18 of the Law "On competition..." subject to behavioural requirements has been continued. The number of negative clearances of stock purchases notifications increased because of the possible establishment or strengthening of a dominant position as a result of a transaction. Based on the results of reviews, in 173 cases the deal was banned. The number of administrative proceedings instituted against cases of violation of the notification regime, envisaged by Articles 17 and 18 (non-submission of application or violation of deadlines) has almost doubled. It is important to stress the positive consequences of a broad application of administrative responsibility measures to such violations. When for 1998 the increase of the number of applications and notifications considered by the antimonopoly authorities amounted to about 28 per cent, for 1999 - the increase was more than 45 per cent.

28. MAP Russia received the notification from OAO Insurance Company "Lukoil" and OOO "Lukoil-Rezerv-Invest" of the foundation of OOO "LK-Garant". According to paragraph 4 of Article 17 of the Law "On competition..." the founders have to notify MAP Russia about the foundation of a new economic entity in 15-days term. It was determined that OOO "LK-Garant" was registered on 06.05.1998 but the notification was presented 8 months later. That means that OAO Insurance Company "Lukoil" and OOO "Lukoil-Rezerv-Invest" violated the notification procedure stipulated in paragraph 4 of Article 17 of the Law "On competition...". The Commission on antimonopoly legislation violation cases of MAP Russia imposed penalty on OAO Insurance Company "Lukoil" and OOO "Lukoil-Rezerv-Invest". On 28.04.99 OOO "Ilbau GmbH" notified MAP Russia about purchasing of 100 per cent of shares in the charter capital of OOO "Grand-Lux". According to paragraph 1 of the Article 18 of the Law "On competition..." acquisition of stocks (shares) resulting in the right to dispose more than 20 per cent of shares can be completed subject to *ex ante* notification to the federal antimonopoly authority. However OOO "Ilbau GmbH" concluded the transaction failing to notify MAP Russia and therefore violating the provisions of Article 18 of the Law "On competition...". The Commission on antimonopoly legislation violation cases of MAP Russia imposed penalty on OOO "Ilbau GmbH".

29. The antimonopoly practice proves the increase of the scale of structural transformations and redistribution of the property rights in the majority of regions of the Russian Federation. Of special significance in the process of economic concentration are privatisation transactions including those made as a result of investment tenders and, also, transactions resulting from bankruptcy proceedings. At the present stage they are accompanied by processes of the property redistribution that demand special

## RUSSIAN FEDERATION

attention aimed at prevention of market monopolisation. The amendments to Article 18 of the Law "On competition..." adopted in 1999 are expected to be of great significance in the process of this kind of control. Moreover, in 1999 by the way of the order of MAP Russia of 13.08.99 • 276 a new Regulation on submission to antimonopoly authorities of applications and notifications according to the Articles 17 and 18 of the Law "On competition..." was adopted.

30. In 1999 MAP Russia considered the case of purchase by the Company "Novolipetsk metalurgichesky combinat" (further - "Metalurgichesky combinat") of the controlling interest of the Company "Studenovskaya aktsionernaya gornodobivauchaya kompaniya" (further - "Stagdok"). "Metalurgichesky combinat" produces and delivers to the Russian market pig-iron and also various kinds of metal sheets. "Metalurgichesky combinat" holds a dominant position on the RF market. The major activity of "Stagdok" is extraction of limestone. More than 90 per cent of limestone is delivered to "Metalurgichesky combinat". Thus, "Metalurgichesky combinat" is the main purchaser of the production of "Stagdok". In February, 1999 in order to improve the economic parameters and financial situation of "Stagdok", the top managers of "Metalurgichesky combinat" and "Stagdok" decided on interaction. At present this interaction made it possible to liquidate the debt on wages and increase the production volume. "Metalurgichesky combinat" presented to MAP Russia the expected economic benefits deriving from the purchase transaction of the controlling stake of "Stagdok". At the same time, "Stagdok" is the only supplier of limestone to sugar production plants of Lipetsk and Voronezh regions. To prevent the restriction of competition MAP Russia suggested to "Metalurgichesky combinat" to unilaterally assume the obligations to secure competition and protection of the interests of entities operating on regional market of technological lime-stone. "Metalurgichesky combinat" agreed with MAP Russia's conditions and, subject to the above requirements, the Metallurgichesky combinat's request was satisfied.

31. The "Rosset Limited" company applied to Moscow and Moscow Region regional office of MAP Russia for positive clearance of the purchase 75 per cent of voting stock in the original capital of OAO "Giprosnab". The clearance was granted subject to the requirement to maintenance of the principal activity of the issuer consisting in accomplishment of projects for organisations of Moscow and Moscow Region providing there is a demand or orders from consumers and possible non-deficit production.

### **3. State control over acts and activities of executive bodies restricting competition**

32. In 1999 the work continued on prevention of illegal acts and activities of executive bodies restricting competition. Norms regulating such control are stipulated in Articles 7 and 8 of the Law "On competition...". Among the cases instituted against anti-competitive acts and conduct of executive authorities and competition restricting agreements between these authorities, the increase in the share of cases concerning suppression of groundless hampering of activities of economic entities, combination of authority competence and economic activities, creation of administrative market entry barriers can be observed.

33. In 1999 the antimonopoly authorities considered more than 1700 of competition restricting acts and activities of state executive bodies at different levels. 646 cases were instituted as a result. The head of Irkutsk administration adopted the decree "On export regulation of commodity resources", which restricted the economic entities' rights to acquire goods by introducing obligatory expert valuation of some exportable product categories. The Irkutsk department of MAP of Russia established the fact of violation by Irkutsk administration of paragraph 1 of Article 7 of the Law "On competition..." and issued the order to relinquish the violation of antimonopoly legislation and to introduce relevant amendments to the decree. The order was executed. The N. Novgorod administration adopted the acts "On regulation of product import and export" and "On state veterinary control improvement in the territory of N. Novgorod". The acts established the administrative barriers to free movement of products on the territory of the region. The

N. Novgorod department of MAP Russia issued an order to terminate violation of paragraph 1 article 7. The order was executed. To prevent the regional separatism, the regional antimonopoly authorities introduced the practice of preliminary consultation of normative acts drafted at the local level. In the 1999 the regional antimonopoly bodies considered 2234 draft acts of executive bodies including 45 per cent of negative conclusions.

34. Anticompetitive agreements with the participation of federal and local executive bodies are usually accomplished as official documents which makes it easy to determine their disparity with antimonopoly legislation (Article 8 of the Law "On competition..."). In 1999 - 82 petitions were considered, of which in 27 cases violations were eliminated by mutual agreement, and 33 cases were instituted. In order to disclose this kind of agreements, regional antimonopoly authorities carried out 38 controls. The experience of the implementation of Articles 7,8 of the Law "On competition..." has shown that the co-ordination with judiciary and prosecution authorities is insufficient. This is one of the reasons why about 60 per cent of the disputes to recognise acts of executive bodies as illegal are judged in favour of the antimonopoly authorities.

#### 4. *State control over unfair competition*

35. Prevention and suppression of unfair competition according to Article 10 of the Law "On competition..." acts in favour of the development of civilised product markets. The biggest number of complaints in 1999 concerned illegal use of trade marks, dissemination of false information and misleading the consumers. The increase in the number of the complaints considered by MAP Russia concerning illegal use of intellectual property should be stressed in particular (183 per cent compared with 1998). One of the complaints submitted by the joint-stock company "Moscow tea fabric" and limited liability Company "Nikitin" concerned unfair competition practices consisting in the illegal use of the trade mark by company "Teastan". The Commission of MAP Russia recognised the action of "Teastan" as violating Article 10 of the law "On competition..." and issued the order to cease violation of antimonopoly legislation. The order was executed. The problem of audio, video and publishing piracy, illegal use of trade, scientific and technical information has not yet been solved in Russia. Unfair competition practices consisting in obtaining, using and divulging of trade, scientific and technical information including commercial classified information without the owner's consent, as well as other forms including these prohibited by Parisian convention on industrial property protection have been less widespread. At the same time the number of cases concerning the protection of entrepreneurs' reputation has been constantly growing.

#### 5. *Statistics*

36. In general, all violations of the Law "On competition..." and measures directed on its suppression in the 1999 can be characterised by the followings data:

The articles of the Law "On competition..."	Considered cases	Initiated legal procedures	Decisions taken
Total-	8398	5466	4194
Including:			
Article 5 (abuse of dominant position)	2097	538	302
Article 6 (agreements restricting competition)	69	41	26
Articles 7,8 (acts and activities of executive bodies restricting competition)	1719	646	444

## RUSSIAN FEDERATION

The articles of the Law "On competition..."	Considered cases	Initiated legal procedures	Decisions taken
Article 10 (unfair competition)	332	158	99
Article 17 (control over establishment, merger, reorganisation, liquidation of economic entities)	1699	1683	1477
Article 18 (control over acquisition of shares, stocks)	1862	1807	1551

### III. The role of antimonopoly body in elaboration and implementation of regulatory reform, trade, industrial and other policies

#### I. *Natural monopoly regulation*

37. MAP Russia exercises the competence over the state regulation of natural monopolies in transportation and communication. The inventories of economic entities operating in natural monopoly sectors regulated by the state have been developed. The inventory of natural monopoly entities in transportation includes 215 entities operating in the railroad sector as well as service providers at airports and seaports. The inventory of natural monopoly entities in communication includes 200 entities operating in TV and radio nation-wide broadcasting. The Regulation on natural monopoly entities inventory in transportation was approved by MAP Russia order 09.07.99 No. 215; the natural monopoly entities inventory in communication – by order 18.01.2000 No. 21. For the decision making purposes in the field of regulation the Board was established in MAP Russia, the functions and competencies of which are determined by Article 9 of the Federal Law "On natural monopolies". The Board members are appointed and dismissed by the Government of the Russian Federation. The principal competence of the Board is to determine the prices (tariffs) in natural monopoly sectors of transportation and communication.

38. In order to promote the effective fulfilment of anti-inflation policy the Government of the Russian Federation adopted the following legal acts: of 03/03/99 No. 253 "On measures excluding unfounded tariff increase on natural monopoly entities products (services) in 1999"; of 13.10.99 No. 1158 "On securing the observation of economically based principles of price (tariff) forming by natural monopoly entities" (elaborated in co-operation with the Ministry of Economy of the RF). The Regulation on consideration of violations of the federal law "On natural monopolies" by federal executive authorities responsible for natural monopolies regulation was elaborated and adopted by the RF Government decree of 24.03.2000 No. 257.

39. In course of accomplishment of the state tariff policy in the field of railway transportation, the increase in efficiency of the Russian transport system functioning, aiming at securing competitiveness of Russian producers and supporting the strategic goods carriers, the governmental commission was created on improving the state tariff policy on federal railway transportation and transportation policy. The procedure of decision making on the discount tariffs formation for transportation of goods was clarified aiming at preventing distortion of competition. In 1999 the overall tariffs level of cargo railway transportation increased by 10 per cent. At the same time the prices of the industrial products increased during January-November 1999 compared with December 1998 by 63.7 per cent. As the result of the state policy of holding back the railway tariffs increase and decreasing the railways operational costs in 1999 the turnover of goods grew by more than 15 per cent compared with 1998.

40. The monitoring of tariffs with respect to the types of goods and the distance of carriage is the necessary prerequisite and the source of information for the decision making process in the conditions of state regulation of tariffs for the railway transportation of goods. According to the above, and also being guided by the recommendations of IBRD and IMF, MAP Russia presented to the Government of the Russian Federation in November, 1999 the report providing the analysis of the tariffs applied for national and foreign rail transportation. The analysis showed that the existence of two systems of tariffs for transportation of goods on the territory of the Russian Federation differing by their structure and tariff levels leads to violation of the principle of "equal profitability" of operations of the federal railway transport, discrimination of some consignees, different interests in kinds of carriage due to sharp difference in the level of profitability. At the same time the scale of cross subsidisation of certain types of carriage at the expense of other simultaneously increases. The disproportion in budget incomes in different regions boosts. As a result, the analysis and development of balanced decisions on tariff regulation becomes difficult. In order to improve this situation it is necessary to wave the existing disproportion: first of by harmonisation of the tariff systems, secondly by introduction of the uniform tariff system, using positive aspects of both tariff systems. The possibility of undertaking tariff regulation decisions without involvement of MAP Russia should also be excluded.

41. Aiming at overcoming the branch crisis in the field of communication the monitoring of financial and economic situation of both the operators and the branch as a whole has been conducted. As a result of this activity 89 new price-lists (for each regional operator) - "The tariffs for communication services falling within the competence of the state regulation of MAP Russia" were elaborated. Individual approach for calculation of tariffs on each type of service was applied. In this respect the Order of consideration and approval of the communication tariffs regulated by MAP Russia was elaborated. In 1999, in 4 integrated regions of Russia the harmonisation of tariffs was conducted establishing similar tariff levels. From 01.06.1999 the new tariffs for regulated communication services, including loss-making public services were implemented. In 1999 the tariff policy conducted by MAP Russia allowed the communication operators not only to save the range of the services rendered, but also to increase it. The number of consumers in local telecommunication markets grew by 4 per cent, the number of interurban telephone calls increased by 23 per cent.

42. The differentiated regional tariffs for nation-wide TV and radio broadcasting were introduced ensuring the reimbursement of expenditures of communication companies (the order of MAP Russia of 13.01.2000 N 14).

43. One of the main directions of activity consists in regulation of mutual settlements of the communication operators. In this respect the methodology of price ceilings in settlements calculation between regional operators and OAO "Rostelecom" for interurban traffic has been improved. The amendment to the methodology of settlements calculation of 01.01.99 providing for separate calculation for every regional operator, made it possible, beginning from 01.06.99 to reduce tariffs for interurban telephone calls and to reduce the liabilities of communication operators to OAO "Rostelecom". Consideration was also given to the disputes concerning mutual settlements between operators. In order to provide for the efficient consideration of the disputes and decision making, the interdepartmental commissions for tariff policy in communications and for enhancement of principles of mutual settlements between communications sector entities were established with MAP Russia. The basic provisions for mutual settlements between fixed telephony network operators and federal mobile telephony networks as well as the principles for setting tariffs for fixed and mobile telephony networks interconnections were elaborated.

44. Measures with respect to tariffs for regulated services in communication undertaken in the middle of 1999 as well as the growth of volume of services rendered provided for the positive economic results in this sphere, namely: positive tendencies were noted in reducing cross subsidising in setting

## RUSSIAN FEDERATION

communication tariffs, growth in the share of communication sector in GDP and in the share of contribution to the consolidated budget, comparable with the growth of this sector share in GDP. Here the gross revenues of the branch increased not due to the growth of tariffs but as the result of the growth of the volume of services rendered.

45. In 1999 tariffs were approved (and partially reviewed) for loading-unloading in 12 seaports and 2 terminals providing reloading freight to sea transport. In 1999, in the majority of seaports of Russia, the growth (30 per cent on the average) of freight turnover was marked as contrasted to 1998. Growth of bulks of cargo processing and competitive tariffs approved by MAP Russia have led to significant growth of the ports' incomes and correspondingly to the growth of tax revenue to the budgets of all the levels. Except for the decisions on revision of the tariffs on loading-unloading in ports and terminals the Board of MAP Russia took decisions on rates of payments in seaports taken by marine administrations of the ports. The decisions were aiming at increasing the attractiveness of the Russian ports for ship-owners and to provide safe navigation in the ports. In 1999 the Board of MAP Russia revised the rates of airports' taxes and tariffs for ground-handling services for Russian aircraft exploiters at 48 airports of the Russian Federation and at 53 airports for foreign aircraft exploiters.

46. The work on restructuring the entities operating in natural monopoly sector of the federal railway transport is carried out in compliance with the Decree of the President of the Russian Federation of 08.11.97 No. 1201 and the Decision of the Government of the Russian Federation of 14.07.98 No. •• - •10 - 20407 "Acting Plan for Accomplishment of the Concept of Structural Reform of the Federal Railway Transport ". The above documents determine specific conditions for removing the supplementary services enterprises not involved in the failure-restoration activity from the railway structure. The list of the above enterprises approved by the Decree of the Government of the Russian Federation of 21.03.98, No. 338 (the version of the Decree of the Government of the Russian Federation of 20.05.99 No. 550), includes 63 state enterprises. In the process of privatisation of enterprises MAP Russia exercised the control of observance of the antimonopoly legislation, as well as the control of reforming processes aiming at preventing the strengthening (establishing) of dominant position or restriction of competition. In course of the reform process, requirements envisaged by "Regulation on the Procedure of Application and Notification to Antimonopoly Authorities in compliance with the requirements set by Articles 17b and 18 of the Law "On Competition..." should be met. In case, the above requirements are not met, as in the case of the restructuring of the Moscow Electro-Mechanical Repair Plant (by merging it with the Moscow Engine-Repairing Plant), MAP Russia does not approve the transaction.

47. The restructuring of the RAO "United Power engineering System of Russia" (UPES) and its subsidiary companies, development of competition in electric energy sector, changes in the approach to state regulation of the branch were carried out according to the Decree of the President of the Russian Federation of 28.04.97 # 426 " On the Basic Provisions of the Structural Reform in the Field of Natural Monopolies", as well as according to the relevant decrees of the Government of the Russian Federation. MAP Russia took part in the development of the RAO UPES restructuring concept providing for the separation of the natural monopoly components (transmission) from the potentially competitive activity (generation and supply), creation of clear and understandable rules for the electric energy markets operation and services, based on the market mechanisms of price formation in the competitive segments of the market; improving procedure and methods of tariff regulation on electric and heat energy in the natural monopoly market segments; providing for the TPA rule, as well as removing entrance barriers to the electric energy and services market; removal of technological barriers and development of organisational and legal conditions for equal involvement of Russian enterprises into the foreign electric energy markets. The work on the Concept has been continued in 2000. On the basis of the Concept the Program for Restructuring RAO UPES will be elaborated which is supposed to attain the status of a state Program.

## 2. *Competition aspects of foreign economic activity*

48. In 1999 MAP Russia continued its participation in the work of the Governmental Commission of the Russian Federation on protective measures in foreign trade and in customs-tariff policy in order to secure the accomplishment of the antimonopoly policy rules, when introducing measures on tariff and non-tariff regulation, as well as aiming at securing the control over support of normal competitive environment on product markets. According to the legislation, the introduction of regulatory measures is possible only with the consent of MAP Russia. Applications from Russian producers on introduction of protective measures against massive import of starched treacle, poultry meat and protection of domestic machine-building and electric-technical producers were considered in 1999. 72 applications from Russian producers on correction of taxes for different industrial, agricultural and medical goods were examined by MAP Russia. When reviewing the questions, the position of applicants on the domestic market, possibilities of the Russian producers to adopt to new conditions of competition, increase of their competitiveness were taken into account. MAP Russia supported 33 out of 51 applications on import taxes, in particular on import taxes reduction for: rolling-mill equipment "2000", on assembly parts for furniture production, on concentrates for juice production, on fat for industrial use, on sunflower seeds, on wool and some other goods; on increasing import taxes on geological equipment; on prolonging the expiry period for increased import taxes for: acetate tourniquet, fluorspar. MAP of Russia upheld 11 applications concerning the correction of import tax rates, including taxes cancellation on items of folk craft, on precious metals, thick sheet and tube half-finished products, etc., taxes reduction for saw-timber. "Methodical recommendation on evaluation of consequences of the proposed protective measures introduction", developed by MAP Russia, was sent to the Governmental Commission of the Russian Federation on protective measures in foreign trade and customs-tariff policy.

49. In 1999 MAP Russia continued the works in the framework of the Commission on WTO, took part in the works aiming at ceasing discrimination of the Russian suppliers on foreign markets, including antidumping procedures. The work has been commenced on the review of applications of the Russian entities claiming the right to realise foreign trade activity in the field of military production.

50. International co-operation of MAP Russia in the field of antimonopoly and entrepreneurial policy was significantly expanded in course of 1999. Active contacts with antimonopoly authorities of the CIS member countries and other countries were carried out. The agreement on co-ordinated antimonopoly policy was adopted in new wording, also the CIS countries adopted the agreement in the field of consumer rights protection for the first time. The Interstate Committee for Antimonopoly Policy was entrusted the competence of the fulfilment of the two international agreements. On October 8, 1999, at the session of Heads of the CIS Governments, Interstate Program for Small Enterprises Support in CIS countries in the years 2000-2001 was approved.

51. Considerable amount of work has been carried out with the OECD and UNCTAD experts. MAP Russia representatives participated regularly in the meetings of the Committee on Competition Law and Policy and its Working Parties and also in OECD competition policy seminars. New directions of co-operation between MAP Russia and OECD were developed and discussed in detail at the meetings of OECD experts in MAP Russia. Taking advantage of these meetings MAP Russia elaborated and submitted to the Ministry of Foreign Affairs of the Russian Federation (MFA) its proposals regarding the Program on co-operation of the Russian Federation with OECD in 2000. The delegation of MAP Russia took part in the meeting of the Working Group on Interactions between Trade and Competition (Geneva, June 1999). Representatives of MAP Russia participated in the most important events in the framework of APEC in 1999. The works were continued in the Russian Governmental Commission on co-operation with EU, also several tasks were completed in the framework of the Perspective plan of actions for the execution of the Agreement of partnership and co-operation between Russia and EU. MAP Russia took part in

## RUSSIAN FEDERATION

preparation of “ Medium Term Strategy of relationship development between the Russian Federation and EU”. Significant projects were completed in the framework of TACIS Programs.

### 3. *Development of small enterprise*

52. Support to entrepreneurship is one of the basic directions of the state policy. As at October 10, 1999 the number of small enterprises amounted to 890000. Every fifth Russian citizen, considering temporal employment and family members, deals with small business.

53. The second Russian Congress of small enterprises representatives was held in October 1999 on the initiative of public organisations of entrepreneurs, the Russian Chamber of Commerce and Industry and MAP Russia with the support of the Russian Government. The Congress attracted attention of authorities to problems of small business, developed proposals on the enhancement of the enterprise climate and consolidated entrepreneurs. Issues concerning business-authorities interaction, the assurance of legal, financial, investment and information securing of small enterprise, issues of labour-social relations at small enterprises, staff training, business security, international programs of small enterprise support were discussed at the Congress. The project of a Decree of the Russian Government “On Establishing the Interdepartmental Commission for Overcoming Administrative Barriers in Entrepreneurial Activity in the Russian Federation” and the project of the Commission Status were elaborated aiming at accomplishment of the Congress decisions.

54. Possibilities of financial state support (state aids) for small enterprises were limited, there has been no financial support for the Federal program of state support to small enterprises from the federal budget for the last three years. That is why the activities of MAP Russia have focused on the elaboration of non-budget and low –cost small enterprise support schemes, in particular through the credit guarantees systems and property support by means of redistribution of ownership. The set of documents providing for the simplified procedure for small enterprise participation in the high-effectiveness projects tendering process financed from the Development budget resources, was developed.

55. One of the main directions of small business support is its involvement in the public procurement contracts. In this respect the proposals for securing the access to public procurement tenders for small enterprise were submitted by MAP Russia. The tax system simplification and reduction of tax obligations seems to be the most important factor of business development acceleration and regulation of interactions between small business and budgets of all levels. Consequently MAP Russia proposals of introduction of the amendments to the Tax Code concerned the reduction of tax obligation for small enterprises and introduction of the unified tax for certain kinds of activities. Proposals to the Government of the Russian Federation on introduction of amendments to The Regulation on costs of production and realisation of production (works, services) and on the financial results formation procedure for taxation purposes are also prepared.

56. In 1999 the interaction between regional executive authorities (in 87 administrative units of the Russian Federation), fulfilling the small business support tasks, became more active. The Public Committee of entrepreneurs to the government of the Russian Federation is being formed. MAP Russia together with other federal executive authorities participates in implementation of the Decree of the Government of the Russian Federation of 22.06.99 # 659 “On measures for support of employment”. Measures for jobs' creation at small enterprises in different economy sectors and for training activities for youth, women, ex-military staff and craftsmen are developed. MAP Russia co-ordinates the activities of interregional studying-consulting centers on assistance to small enterprises' development.

**IV. Resources of the competition authorities**

**1. Annual budget**

57. In 1998 (by 01.01.98) the year budget of the competition authority (MAP Russia) was Roubles 39317,0 thousand (\$ US 6,6 million). In 1999 – Roubles 96064 thousand (\$ US 4,7 million).

**2. Human resources**

58. 1834 persons (417 people-central office of the Ministry, 1417 persons – Regional Offices), among them: economists- 572, lawyers-343.

59. In 1999 there were 868 officers dealing with the issues of antimonopoly legislation control, 128 – with advertising legislation, 328 – with the legislation on consumer rights protection. The numbers include the employees in the central Office and Regional Offices of MAP Russia.

**V. References to new reports and researches in competition policy**

60. For the purposes of this Report new scientific reviews and researches on competition and economic policy were used:

- Competition law of the Russian Federation, N. I. Clein, N. E. Fonareva, Moscow, Logos, 1999;
- Competition and antimonopoly regulation, under editing of A. Tsyganov, M., Logos, 1999;
- Theory of local market organisation, Avdasheva S.B., Rozanova N.M., M., Magistr, 1998;
- Contracts and costs in resource-supplying sub-branches of house-utilities, Shastitko A.E., Bureau of economic analysis, M., TEIS, 2000;
- Alternative forms of economic organisation in natural monopoly conditions, Shestitko A.E., Bureau of economic analysis, M., 2000;
- Competition restriction on regional market of goods and services by local executive and managerial authorities (the review of the Russian practice in 1990-s), Bureau of economic analysis, M., TEIS, 2000;
- Analysis of integrated structure role on the Russian goods market, Bureau of economic analysis, M., TEIS, 2000;
- Analysis of the external environment of development, TACIS, August 1998;
- Monopolism and antimonopoly policy, the Russian Academy of Science, M, “Science”, 1994;
- State regulation of natural monopolies. Experience, problems, perspectives, Sankt-Petrburg, 2000.

# **EXHIBIT 19**

Source: [All Sources](#) > [Secondary Legal](#) > [Law Reviews and ALR](#)   
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**NOTE: LIFE IN RUSSIA'S "CLOSED CITY": MOSCOW'S MOVEMENT RESTRICTIONS AND THE RULE OF LAW**

Damian S. Schaible\*

\* This Note is dedicated to the memory of John Joseph Ostertog (1917-2000), who taught me so much. I would like to thank Professor Alexander Domrin for his helpful comments, and the members of the New York University Law Review, especially Margaret Lemos, David McTaggart, Michael Russano, and David Yocis, for their excellent advice and editorial assistance. I would also like to thank my family for their constant support and encouragement.

**SUMMARY:**

... With the downfall of the Soviet Union and **Russia's** rebirth as a state committed to democracy and capitalism, all of this was supposed to change. ... B. Unenforcement of Federal Law as an Index of Progress Toward the Rule of Law in **Russia ... Therefore, if Russia** is operating under the rule of law, one could expect that federal law, within its sphere of influence, would override inconsistent local actions. ... C. Unenforcement of Federal Law Exacerbates the Problem of **Russia's** Transition to the Rule of Law ... " Moscow's continued flouting of federal law further damages the prospects for such a legal consciousness in **Russia**, thereby hindering **Russia's** transition to the rule of law. ... It is clear both that building a legal consciousness in **Russia** is vital to the successful transition to the rule of law, and that it will take time. ... In this way, the continued rift between federal law and local reality on the subject of free movement illustrates the difficulty **Russia** faces in instituting the rule of law. ... Second, the maintenance of movement restrictions in the face of contrary federal law worsens **Russia's** ability to attain the rule of law. ...

The City of Moscow continues to enforce a restrictive residence registration regime similar to the propiska system that prevailed in the Soviet era - despite constitutional guarantees of the freedom of movement, federal statutory provisions implementing that right, and Constitutional Court rulings that such restrictions are unconstitutional. In this Note, Damian Schaible argues that the continued restrictions represent more than simply an ongoing violation of the human rights of Moscow's illegal residents; they are also an indicator of Russia's imperfect transition to the rule of law and a practical obstacle to the success of that transition.

**TEXT:****[\*344]** Introduction

In October 1999, while Moscow was gripped by terror in the wake of a series of apartment bombings, 20,000 people in the city were arrested and detained by police, <sup>1</sup> while another 15,000 were ordered to leave the city. <sup>2</sup> A family of three was told one morning that they had twenty-four hours to vacate the apartment where they had lived for seven years and to leave Moscow. <sup>3</sup> There may be as many as three million other people, still living in Moscow, who are effectively nonpersons in the eyes of local law. <sup>4</sup> They are unable to vote, marry **[\*345]** legally, send their children to school, receive aid from public assistance programs, or receive the free medical care offered to the other residents of the city. <sup>5</sup>

These stories and others like them are the direct result of Moscow's residence registration law. Originally instituted by Peter the Great early in the eighteenth century, residence permits were used to tie Russian serfs to the land. <sup>6</sup> Stalin reintroduced the system in 1925 as a means of controlling the movement of Soviet citizens to prepare the country for the rapid and painful industrialization that came to be called the "Great Terror." <sup>7</sup> Administered through the use of a residence permit stamp, or propiska, imprinted in an "internal passport" that all Soviet citizens were required to carry, the system severely restricted movement throughout much of the Soviet era. <sup>8</sup>

With the downfall of the Soviet Union and Russia's rebirth as a state committed to democracy and capitalism, all of this was supposed to change. <sup>9</sup> Today, nine years later, it is clear that the federal government of Russia recognizes its people's right to choose a place to live and to move freely about the country. The 1993 Russian Constitution acknowledges the right to freedom of movement. <sup>10</sup> The Russian legislature has enacted laws dealing with the right to freedom of movement. <sup>11</sup> The Russian President publicly has supported the right, <sup>12</sup> and **[\*346]** the Russian Constitutional Court repeatedly has declared the right. <sup>13</sup> Furthermore, international conventions signed by the Russian government have promised the right. <sup>14</sup> However, in many parts of the country, including the capital city of Moscow, the federal right to free movement is violated daily by local and regional governments that retain unconstitutional and inhumane propiska-like <sup>15</sup> systems of registration for both visitors and residents. <sup>16</sup>

In addition to the obvious and troubling human rights abuses inherent in these systems, the rift that exists between federal law and **[\*347]** local reality speaks to Russia's difficult transition to the rule of law. <sup>17</sup> The rift can be understood in two related ways. First, it provides an index, showing how far Russia is from its goal. In addition, it creates a vicious cycle in which illegal restrictions on movement persist because Russia remains far from the rule of law, while the continued restrictions in turn make the problem worse. This does further damage to Russia's prospects for attaining the rule of law. This Note recognizes that the government is not likely to remove the restrictions in the near future. However, this Note argues that ultimately they must be removed if Russia is to have a genuine chance at achieving the rule of law. <sup>18</sup>

Part I focuses on the ongoing problem of movement restrictions in Russia, examining the discarded Soviet propiska system, Moscow's current restrictive residence registration system, and the human rights implications of Moscow's registration regime. Part II then examines how the split between federal law and local reality with respect to Moscow's restrictions on movement speaks to Russia's prospects for becoming a nation governed by the rule of law. It explains that the rift provides an indicator of how far Russia is from the rule of law, while at the same time worsening Russia's prospects for ever attaining the rule of law. The Note concludes by arguing that, despite the difficulties involved, if the nation is to attain the rule of law, Russia's leaders must act to enforce the federal right to free movement.

I

In addition to the explicit restrictions on registration created by the system, actions taken by Moscow's leadership, especially the city's powerful Mayor Yuri Luzhkov, have restricted people's right to move around freely even further. <sup>59</sup> One such action occurred in September 1999, when, in the wake of a series of apartment building bombings in Moscow that were widely thought to have been perpetrated by terrorists in retaliation for Russian action in the breakaway Republic of Chechnya, Luzhkov twice tightened Moscow's registration requirements. On September 13, 1999, Luzhkov, ostensibly to unmask the perpetrators of the apartment bombings, issued a decree that all people with temporary registrations in Moscow had to reregister within three days. <sup>60</sup> When it became obvious that local authorities could not **[\*355]** possibly process the reregistration applications of the 121,000 people who had temporary registrations in Moscow, the Mayor extended the period to September 21. <sup>61</sup>

There are several aspects of Mayor Luzhkov's September 13 decree that show that registration - and therefore movement - continues to be restricted in Moscow. The mere fact that people legally registered were forced, with little notice, to stand in long lines for up to a week to reregister, <sup>62</sup> can be seen as a restriction. More significantly, many of those who previously held temporary registrations were denied reregistration. In the week after Luzhkov's decree, 15,000 previously registered visitors were refused reregistration and told to leave the city within three days. <sup>63</sup> Even more troubling, one human rights monitor in Moscow reported that the Moscow police were operating under unpublished, yet explicit, orders to refuse to register any ethnic Chechens residing in the city. <sup>64</sup>

Finally, the September 13 decree added to the requirements for temporary registration in Moscow. Item 1.2 of the decree required those seeking reregistration to substantiate their purpose for being in Moscow. <sup>65</sup> One advocate for the unregistered in Moscow explained that though there are no rules to define acceptable purposes, a letter from an employer usually is required. <sup>66</sup> According to a statement made by the head of Moscow's passport department, those refused **[\*356]** reregistration in the wake of the September 13 decree were rejected because "they were unable to explain the purpose of their presence, their place of residency and, well, a number of other reasons." <sup>67</sup> Calling for reregistration arguably is restrictive of free movement; however, the number of people refused reregistration and the suspect reasons for refusal make it clear that movement continues to be restricted in Russia's capital city. <sup>68</sup>

In sum, it is clear that Russia's capital city continues to prevent free movement by the use of a registration system that operates in various ways to restrict severely who can register in the city. <sup>69</sup>

#### D. The Human Rights Implications of Moscow's Continued Restrictions on Movement

Moscow's registration system, by restricting who can register in the city, significantly violates the human rights <sup>70</sup> of the unregistered. <sup>71</sup> **[\*357]** Life for the unregistered, commonly labeled "bomzhi" (an acronym for one without an address and a colloquialism for "scum"), <sup>72</sup> is extremely difficult. They cannot enroll their children in kindergarten, they are denied the free medical care available to other Muscovites, and they are not even allowed to buy a gravesite. <sup>73</sup> They are unable to get a job legally or receive a pension. <sup>74</sup> They are stopped frequently and questioned by police and are forced to pay bribes to avoid being taken into custody for not being registered. <sup>75</sup> When they are taken into custody, they face beatings at police stations and are held in special deportation centers while they await deportation from the city. <sup>76</sup>

**[\*358]** In short, the restrictions result in a class of Moscow inhabitants who effectively are treated as noncitizens. <sup>77</sup> This class of people whose human rights are violated by the registration regime is not a small one; <sup>78</sup> as mentioned, widely varying estimates place the number of unregistered in Moscow somewhere between 100,000 and three million. <sup>79</sup>

in the movement of Russian citizens is as record keeper.

### **[\*367]**

#### 2. The Continuing Rift Between Federal Law and Local Reality

A month after the Constitutional Court's last ruling, it became evident that it would prove as ineffective at removing movement restrictions in Moscow as had all of the previous legislation and court rulings. In March 1998, Moscow Mayor Luzhkov announced that he would ignore the ruling.<sup>128</sup> Constitutional Court Justice Vladimir Yaroslavtsev rebuked Luzhkov in a public statement, exclaiming: "We would like to warn Luzhkov and other regional heads: There will be no closed cities!"<sup>129</sup> Yet commentators agree that this is exactly what Moscow remains to this day - an effectively closed city.<sup>130</sup>

Though clear in its holdings and requirements, federal law - in the form of both legislation and court rulings - has not been given effect in Moscow and other cities.<sup>131</sup> Part of the blame for the continuing rift lies with federal legislators, who fail to express a strong desire to enforce the people's right to free movement that is embodied in the laws they pass.<sup>132</sup> Though the Russian Constitution creates a federation, with federal law supreme,<sup>133</sup> as one writer reported, "the federal government has long turned a blind eye to Moscow's violation of federal rules, effectively allowing the city to become a state within the state."<sup>134</sup>

**[\*368]** For example, a draft resolution was introduced in the Russian State Duma shortly after Mayor Luzhkov issued the September 13, 1999 reregistration decree.<sup>135</sup> The resolution, which would have called on the Moscow government to bring its registration regime into line with the Russian Constitution, was defeated by a vote of 62 in favor and 136 against.<sup>136</sup>

In addition to failing to enforce legislation, federal leaders also have failed to enforce the decisions of the nation's judiciary. Judicial review of the law to ensure that those laws conform with the constitution is considered a vital element of the rule of law.<sup>137</sup> Yet, it is not enough that the judiciary be able to interpret what the law means; its interpretation must be enforceable.<sup>138</sup> Elected officials must respect the courts, and must uphold and enforce their decisions.<sup>139</sup> In fact, according to Russian Constitutional Court Justice Nikolai T. Vedernikov, by examining the amount of judicial power and the extent to which judicial decisions are enforced by other parts of government, "it is possible to determine to what degree a state ... corresponds to the demands of the law."<sup>140</sup>

The ongoing disunion between the will of the federal government, as expressed by the Constitutional Court and the practice in cities such as Moscow, demonstrates that Russia's officials do not respect and uphold the decisions of the judiciary. This is particularly problematic because judicial departments generally do not have their own enforcement mechanisms.<sup>141</sup> Russia is no exception, for the Russian Constitution does not enable the judiciary to enforce its own rulings.<sup>142</sup> Therefore, the courts rely upon the nation's elected officials **[\*369]** to enforce their decisions.<sup>143</sup> Unfortunately, Russia's elected leaders - from executive officials to members of parliament to local politicians - frequently ignore rulings by the courts. This runs counter to Russia's desire to create a rule-of-law state<sup>144</sup> and indicates how far removed Russia is from the rule of law.

Though federal leaders merit blame for failing to enforce federal law on the subject of free movement, they are only part of the problem. Since Russian federal law is supreme,<sup>145</sup> and federal law outlaws a system such as Moscow's,<sup>146</sup> local Moscow leadership should feel compelled to change its system simply because it runs contrary to controlling federal law. The fact that it does not further illustrates how much Russia yet has to accomplish in order to achieve the rule of law.

#### C. Unenforcement of Federal Law Exacerbates the Problem of Russia's Transition to the Rule of Law

Thomas Jefferson once wrote that "it is the will of the nation which makes the law obligatory."<sup>147</sup> When the people of a nation are focused on the law, the law binds its leaders. They feel a pressure, exerted by societal norms and the threat of discovery by constituents, to subordinate themselves to the law. This popular focus on the law is called legal consciousness, and as one commentator put it, "[a] well developed legal consciousness ... [is] an important pre-requisite to a law-based state. In its absence ... institutions of the state ... would [not] respect legal norms."<sup>148</sup> Moscow's continued flouting of federal law further damages the prospects for such a legal consciousness in Russia, thereby hindering Russia's transition to the rule of law.

Historically, Russian society has placed less importance on what the law actually says than have many western societies.<sup>149</sup> For example, in the 1800s, a defendant in a Russian imperial court had the choice of being tried on the law (with the decision based on what the **[\*370]** law said) or on the conscience (with the result depending on what was deemed to be "right").<sup>150</sup>

Commentators explain that though Russia did not have a well-developed legal consciousness before the Soviet period, whatever did exist was destroyed under the rule of the Communist Party.<sup>151</sup> During that period, the law was a "flexible tool" of the Party, used as an instrument for imposing State policy on the people.<sup>152</sup> The judicial system fared no better. In the Soviet period, Russian courts were controlled and manipulated by the Communist Party, which dictated decisions to suit its desires.<sup>153</sup> Though the Soviet Constitution provided for individual rights, the courts rarely invalidated governmental actions that threatened them.<sup>154</sup>

Though the Russian people now live in a nation striving for the rule of law,<sup>155</sup> with a judiciary that seeks to apply the Constitution fairly to their cases,<sup>156</sup> the Russian people remain suspicious of the law.<sup>157</sup> Both the legal system and the judiciary are saddled with a past that hinders their legitimacy in the minds of Russian citizens.<sup>158</sup> As one commentator put it, the Soviet period in Russia "was the antithesis of the rule of law and a period that established a strong and unfortunate legacy for the contemporary period."<sup>159</sup>

It is clear both that building a legal consciousness in Russia is vital to the successful transition to the rule of law,<sup>160</sup> and that it will **[\*371]** take time.<sup>161</sup> However, Moscow's continued flouting of federal law and Constitutional Court decisions in the area of movement restrictions leads to a vicious cycle that only heightens the legal system's popular legitimacy problem and thereby further hinders the transition.

Both Thomas Jefferson and more contemporary commentators would agree that the burden of pressuring Russia's leaders to submit to the law and to decisions of the judiciary lies with the Russian people.<sup>162</sup> While this burden is likely well placed, Russian citizens' lingering suspicion of the law and the judiciary make it less likely that they will choose to carry it, thereby leaving their leaders free to ignore law and judicial decisions.<sup>163</sup> Continued refusal to submit to the law and judicial decisions on the part of Russia's leaders, in turn, will do further damage to the legitimacy of the legal system and the courts.<sup>164</sup> Actions that flout federal law, such as those by Moscow's leaders, work to lessen the influence of future laws and court rulings, thereby hindering the growth of the legal consciousness needed in the country for the rule of law to take hold.

## Conclusion

Though one may not be able to pinpoint the exact reasons behind Moscow's desire to retain restrictions on movement,<sup>165</sup> one thing is certain: The restrictions can continue only because of Russia's failure fully to embrace the rule of law. In this way, the continued rift between federal law and local reality on the subject of free movement illustrates the difficulty Russia faces in instituting the rule of law. At the same time, the rift damages Russia's ability to

# **EXHIBIT 20**

[Go To Best Hit]

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[Interview with Tamara Morshchakova by Natalya Arkhangelskaya; place and date not given: "Vulnerable Immunity: Society Has No Confidence in the Judiciary and Has All Too Many Grounds for This"]

[FBIS Translated Text]

The progress of judicial reform is analyzed in an interview with Ekspert by Tamara Morshchakova, deputy president of the Constitutional Court of the Russian Federation--an author of the blueprint of the latter. She became a member of the sparkling brand-new Constitutional Court in 1991--in the first wave. Tamara Georgiyevna is to quit her office this spring--on age grounds. But a number of her coeval colleagues will remain to stand on guard of constitutional legality here. And thank God. Because 65 is the age of the highest human wisdom which, together with high professionalism, affords a resource of which it would be foolish not to take advantage for the good of society. The special case of Justice Morshchakova, though, to whom for some reason or other the recent amendments to the statute governing the Constitutional Court extending the term of its members did not apply, shows once again that the endeavor to politicize our judicial system remains strong and that it remains as yet only to dream about the uniform application of the law. So, about judicial reform.

[Morshchakova] I must confess that in the fight for the sacred cause of independence of the court we did go somewhat overboard. At the start of the 1990s we believed that the court could be truly independent only if it took everything into its own hands. As a result, finances (which we took away from the Ministry of Finance), enforcement of judgments (the courts need a man with a gun), career advancement of judges, and procedural ways of

influencing the courts (reversal of judgments) came to be in a single pair of hands. The Supreme Court, though, came to have not only the material and executive machinery, not only the professional judicial associations, but also the academy, which teaches judges. Plus the right to give binding instructions of a general nature explaining the law, which for judges locally mean more even than the law itself. Unique acts, which no one can review--acts of the Supreme Court of Arbitration and the Supreme Court in explanation of the laws--appeared. And, after all, they virtually formulate the provisions of the law. Our judicial system in its present form is very imperfect, but the problem will not be resolved by a turning back, not by counterreforms, but by forward movement. The shortcomings of the oft-criticized judicial reform ensue precisely from the fact that it has not been completed.

[Arkhangelskaya] When did the reform of our judicial system begin?

[Morshchakova] The first big change came back in Soviet times. More, it began in 1988 with the official documents of the 29th party conference: it was there that the ideas of the formation of an independent judiciary were heard for the first time. Our Institute of Legislation had worked for a long time on this, and we sent our reports to the pertinent department of the CPSU Central Committee, explaining how to ensure that judiciary power be civilized and be a power. And they listened to us there. Then these ideas become part of the blueprint for Russia's judicial reform. With the appearance of a very important law--on courts of arbitration--a separate branch of jurisprudence emerged: the first glimmer of specialization in our judicial system, in which all matters were in a single pile. Yet overseas there are separate courts for financial, labor, and social cases and for the affairs of minors. And they all operate only the better for the fact that they handle special issues.

[Arkhangelskaya] The idea of the unity of the judicial system was cultivated in the USSR....

[Morshchakova] ...misunderstood as the subordination of all courts, whatever they did in terms of their jurisdiction, to a single body--the Supreme Court. And it is particularly dangerous that it is now coming to be revived. Unity of the judicial system is essential, but it is secured, first, by the fact that there is a federal judicial system, not one comminuted into apanage principalities (15 leaders of components of the Federation attempted to challenge the law on the federal judicial system in the Constitutional Court, incidentally: we defended it). Second, unity is secured by the execution of federal laws and the constitution, which have priority in the sphere of administration of the Federation and in the joint administration of the Federation and the components. All judges have a common status. This is what constitutes unity, by no means the fact that all cases are adjudicated by courts of one jurisdiction. The will of the highest court in the judicial hierarchy generally, though, may be embodied only through procedural decisions: if a lower court has made an incorrect judgment, it will be reversed by a superior court. Only thus.

[Arkhangelskaya] In what do you see the indications of counterreforms?

[Morshchakova] We hear the statements: we have no need of courts of arbitration, we have no need of the Constitutional Court, all should be unified beneath the aegis of one court. The idea of the separation of administrative justice is being called in question, although we have already, seemingly, reached the understanding that this is a particular type of legal proceeding--consideration of cases in which acts of public authority are appealed. After all, the administration of justice is not the institution of proceedings against

a citizen who has wrongly crossed the street. Judgment needs to be passed on the bureaucracy. Not only on prescriptive decisions but also on individual acts of a public authority, what is more.

[Arkhangelskaya] But Vladimir Putin has called judicial reform a priority objective, and a special commission, which is directed by one of the people closest to him--Dmitriy Kozak, deputy presidential chief of staff--has been formed.

[Morshchakova] Yes, it set about things very vigorously. A whole stack of reports has already been prepared for the commission. But this is what is depressing: the employees of the judiciary themselves are beginning to demolish the fundamental principles of this reform. The lifetime appointment of judges, for example. A proposal that age limits for them be introduced or their terms limited is suddenly being made: such reports are with Kozak's commission.

[Arkhangelskaya] There are big complaints about the judges....

[Morshchakova] Yes, certainly. I'll tell you one story myself. A citizen complained to the Constitutional Court that he had been beaten up right there in the courtroom. He was the plaintiff in the case: that is, it was not even the defendant but the plaintiff that was beaten up. He applied to the courts for compensation since he had to undergo medical treatment. Not to mention the mental anguish even. And the court wrote to him: a judge cannot be proceeded against for anything that has to do with his judicial activity--complaint dismissed.

[Arkhangelskaya] This is what constitutes judges' immunity?

[Morshchakova] I called the Supreme Court: do something. Were he to kill someone in the courtroom, we would not lay a finger on him even then? I did so much explaining to the professional judicial associations: you do not have the right to refuse to institute criminal proceedings against a judge if he has committed a crime: you are invested with only one obligation--to examine whether the charges against him are connected with his activity as a judge or not and whether revenge is not being taken on him, a criminal case having been artificially created. Many sincerely believe that they may grant permission or otherwise.

[Arkhangelskaya] All-around defense?

[Morshchakova] Exactly. The trouble is that the judicial community, having no forms of control on the part of the body politic, begins to pursue self-protection instead of ridding itself of miscreants. All questions of judges being relieved of office today should be decided by the professional associations. But access to these bodies should be barred to the higher judiciary. The latter may, theoretically, only raise the question of a judge's resignation. In practice, though, the higher judiciary not only raises these matters but influences the decision on them also. For identical violations of the timeframe for the consideration of cases, say, one judge may be proceeded against, another, spared. In addition, the associations exist under the auspices of the courts--oblast, kray, republic--although they are considered independent: they simply have no other organizational base. Consequently, there is already adhesion--the court and the association. Finally, one further important detail. A judge has rendered a judgment of acquittal, say, and the prosecuting attorney says: he is not following our policy of stepping up the fight against crime--this judge should be removed. To prevent such things occurring, the associations were purged of all but

judges. But no provision for their openness was made here: society does not know how they operate.

[Arkhangelskaya] Many people are proposing that representatives of the public be brought in here.

[Morshchakova] I share this idea and am expressing it constantly. Let one-third of the members of the association be composed of public figures, legal students and experts, let them simply be people who are respected in society. And then the transparency of the activity of the associations would be assured. Nothing more is needed. But, instead, calls for us to dispense with these associations altogether--they are bad--are already being heard. One further new idea stemming from the well-forgotten old ones: let's appoint judges for 15 years. And then what? A reappointment? I guarantee you that the judges would for all 15 years be working up to their future position--either in court or elsewhere. They would be earning for themselves the right to work somewhere afterward. Because after 15 years, what is a student of law to do? Earlier we first reelected a judge every five, then, every 10, years. And he would tremble in the party committee, which recommended him. What, then, you want telephone law back again? We do not have this here now. But we have something else instead: a judge is simply bought. It is this that we should be fighting, instead, ideas reinforcing the judicial bureaucracy are being put forward. It is being proposed, for example, that the president of the Supreme Court be entitled to transfer a judge wherever he wants, from one region to another. And bargaining would begin: you want to go to a good city? You behave well.

[Arkhangelskaya] What is the administration's position?

[Morshchakova] Perfectly reasonable proposals are coming from there: for the institution of proceedings, for example, against representatives of power for noncompliance with the decisions of the Constitutional Court--by analogy with the way in which it is now being proposed to institute proceedings against the executive and the legislature of the components for noncompliance with federal laws. But remember what the president said in respect to RAO YeES : restructuring cannot be undertaken by the agency itself. Now take a look at the members of the commission. There are representatives of science there, of course, but they do not constitute the majority. And, then, what can scientists counterpose to the highest judicial officials? The first deputy president of the Supreme Court is on the commission, the first deputy president of the Supreme Court of Arbitration, also. The Constitutional Court voluntarily declined: we are represented there by an expert. But such conduct appears ridiculous when all around are playing by different rules. And what is the result? The judicial bureaucracy pushes decisions that guarantee it a comfortable life. In addition, deputies from various factions, each of which defends his own political interests, is present on the commission.

[Arkhangelskaya] For instance?

[Morshchakova] The Yabloko deputy Yelena Mizulina is actively lobbying for an idea that has been around since the time the constitution was adopted. We are talking about the formation of a supreme judicial presence as an institution that would be above all courts. And what is being proposed is not simply a coordinating authority, what is more--they want to endow it (both now and then) with special judicial functions. I remember with gratitude Boris Yeltsin, who in 1993 found time to meet with the justices of the Constitutional Court

who took exception to this and agreed with our arguments. What is most interesting is who is to constitute this presence: presidents of the courts and their deputies, representatives of the Ministry of Justice--the top bureaucracy, that is. It is not just that it would be the superintendents themselves who would be meeting, they would, in addition, have the right to give directions to other courts. Can you imagine it? And here is the list of proposed functions: interpretation of the constitution, removal from office of federal judges, examination of cases on the constitutionality of judicial practice. That is, an artificial superstructure over the judicial system, which could limit the role of the Constitutional Court, the Supreme Court, and the Court of Arbitration, is proposed. There is a milder version of this idea, it is true--a consultative council, which could decide, say, personnel matters and pursue the fight against corruption in the judicial corps. But there needs to be very serious discussion of its composition and functions here also.

[Arkhangelskaya] You said that complaints about the Constitutional Court also are heard in the commission?

[Morshchakova] Yes, many people are tormented by ideas for reorganizing it for some reason or other. Of all the judicial institutions, it is the youngest and, according to poll results, the one that evokes the most trust in society. We make no secret of our judgments--they are always published. The other courts are categorically opposed to this openness, and with good reason: simply incompetent decisions are often made. The Constitutional Court is far more accessible because when a citizen applies with a petition for review to the Supreme Court, he is written a letter by some member of the court: there are no grounds for lodging a protest. That's it. But with us, if a citizen applies to us even on a matter that we cannot consider on account of our jurisdiction, he can demand that a judgment be rendered by the court in banc. And all 19 justices explain to the citizen why we cannot consider his case and who can adjudicate it. This is an entirely different level of relationship.

But we are told: no, the jurisdiction of the Constitutional Court is unduly broad. It may at this time examine a law from the viewpoint imparted to this law by judicial practice, and our critics say: what business of yours is our judicial practice? But the content of a law is only revealed in its application. Everyone knows that our legal practice is not what it could be, to put it mildly.

[Arkhangelskaya] You could be reproached with defending the Constitutional Court because you yourself are a part of this entity.

[Morshchakova] There's nothing subjective here. Why is the Constitutional Court better than the others? Because it did not come from prehistoric times, it is entirely new-fledged and does not have the birthmarks of our nonlegal past. All that is best has been taken from the bodies of legislation of other countries and adapted to our reality, and all that has shown itself incorrect has been cut off: instituting proceedings on one's own initiative, for example. Everything has now been shaken up. And now our judiciary, which came from a past that was not the best, is treading on the first shoots of the new--the Constitutional Court and the Court of Arbitration.

[Arkhangelskaya] Nonetheless, to my philistine view, our main problem is the legal conscience: of both the citizenry and the judges.

[Morshchakova] And, you know, these things interface, however strange. The level of the legal conscience and legal culture here is patently inadequate. Whence it ensues that our legal conscience and legal culture cannot correct a bad law. Take Germany, for example: it has an old, ghastly law, which, nonetheless, is ideally applied--so that it does not evoke the censure even of the European Court. The Germans do not recognize the principle of adversary pleading--they have inquisitional proceedings aimed at establishing the truth. But they take one sole little letter of the law and say: everyone must be assured of access to the courts. And this is honored so consistently and punctually that the question of adversary procedure does not arise. We, though, write "adversary procedure" and many other good things, but you can't get to the judicial authorities.

Correcting our bad law through the legal conscience is almost impossible, therefore. In many cases this is done by the Constitutional Court, but this is not enough. A most serious problem is the shortage of judges. And it is sometimes proposed that we arrive at the following proportion here: one judge per 10,000 of population. But we would then have to reduce their number because we currently have more. Whence this odd proposal if the aforementioned Germany has 60,000 judges for the country, and we have only 16,000? We cannot, after all, be compared either in population or in territory or in level of the legal conscience.

[Arkhangelskaya] We also, incidentally, essentially have inquisitional, not adversary, judicial proceeding. In addition, the judicial corps is formed mainly from representatives of the prosecutor's office--this is why an accusatory bias is predominant in the courts. Some people are proposing in this connection that that future judges necessarily be admitted via the legal profession.

[Morshchakova] An absolutely utopian idea: attorneys would never go along with this. Why? You see, when an attorney overseas wants onto the bench, he knows that he will have very high status and that he will not have to be thinking about any pay there--his status will take care of all this for him.

[Arkhangelskaya] Yes, status is needed. Lest a trial be held in a rundown basement, where even a judge's gown looks out of place.

[Morshchakova] I agree. And what, then, ultimately, do we need? Many judges, who are paid well, and installed in normal premises. But I would, all the same, make an expansion of the judicial corps paramount.

[Arkhangelskaya] Well, this is, admittedly, a more or less supportable objective. It can be accomplished more rapidly than a change in the legal conscience, in any event.

[Morshchakova] It all depends on how this is stimulated. And society is developing very rapidly, incidentally, in the sense of the legal conscience. A citizen comes to the Constitutional Court--this is something entirely new. And he, having read only the constitution and the statute on the Constitutional Court, defends his rights very competently. An individual entrepreneur comes to us and defends his rights in complicated tax relationships, where the judge has a hard time figuring things out. Why? Because he has not been oppressed: you can't do anything, just sit there quietly, you are forbidden to do anything. He was claimed by the situation, by life.

[Astrakhanskaya] Why is he not defended by the courts of arbitration?

[Morshchakova] The plaintiff has already been there. The tax laws allow of an arbitrary interpretation. The main trouble with us is, after all, the fact that there is no unified legal approach. We can bring up Gusinskiy, let's say, on a **fraud** charge and do not press charges against another just like Gusinskiy. Yet there should be liability in all instances. It could be a tax penalty, a **customs** penalty, a sanction under criminal law, but there should be such.

[Arkhangelskaya] But it is here that we will be doing nothing for a long time, in my view.

[Morshchakova] This will depend on the executive. We need to begin by instituting proceedings against representatives of the executive for failing to ensure the uniformity of application of the law. And we need to hold the prosecuting attorneys to account for this first and foremost. It could be a question of disciplinary liability--expel him from these ranks, certainly. But liability should be inevitable.

[Arkhangelskaya] Are there statistics that bear out the growth of the citizens' interest in the courts?

[Morshchakova] The number of citizens' petitions to the courts--with complaints about power--has increased tens of times over. The law on appeals against the actions of power was silent in the first years, as it were: there were around 1,000-2,000 petitions a year. Today there are tens of thousands of them. The Constitutional Court rendered in the first five years as many judgments as subsequently in two years. The Constitutional Court received approximately 56,000 appeals in the period 1995-2000. Some 10,000-12,000 appeals a year. In 1997-1998 the Constitutional Court examined 59 cases in open court. To compare: 42 were examined in the previous two years, and in the previous five years, 72. This in open court. Yet what we adjudicate not in court, for protection of the citizen, is at times of no less importance. We explain to him how he may defend his rights--as far as the European Court.

[Arkhangelskaya] Do our citizens have an interest in the European Court?

[Morshchakova] It already has thousands of petitions from Russian citizens, and proceedings have been initiated in approximately 600. These people are essentially, after all, suing the state in the person of its judicial authorities--this is what our judicial system is unwilling to understand. It should reform itself so as not to be the cause of complaints about our state in the European Court.

[Arkhangelskaya] This is, in fact, a vote of no confidence in our justice.

[Morshchakova] Yes. Here is an absolutely simple thing. There is the principle of the lawful judge for each case. This is a constitutional principle formulated, in addition, in the Universal Declaration of Human Rights. This means that the judge who is to examine a case must be determined by law prior to the petition having arisen. The matter that is examined in this specific court is determined, that is. And the case cannot be removed--from this court or from this judge. But now--within the framework of judicial reform--it is being proposed here that we create a superior court, aside from the Supreme Court, that can take away any case and initiate proceedings in it. This means that people have

absolutely no idea of the roots from which our judicial history comes: we had such a law, it is called the law of evocation. And we were always criticized for this because in practice this deprives the citizen of the opportunity to negotiate all judicial instances for his defense, that is, it reduces his safeguards. Consequently, the European Court would immediately demand redress. And the Supreme Court (or some new body), having removed this case from the jurisdiction of a normal court, would be the cause of the state paying the plaintiff large sums of money.

[Arkhangelskaya] A horror....

[Morshchakova] Anything, even something good, could turn into a horror under our conditions. We wanted an absolutely independent court to avoid having people say: aha, the Ministry of Justice influences it, let it manage its own finances, we will create a special department under the auspices of the Supreme Court. We did so. And what does the money go on? We read in the accounts: we managed in the past year to spend an additional R152 million on the support of courts of general jurisdiction. But it turns out that they were taken from the sums allocated for the formation of magistrates' courts. Well, in that case some control is necessary. If allocated for magistrates' courts, this means the federal budget, in that case the Comptroller's Office should be monitoring it.

[Arkhangelskaya] This is altogether arbitrary rule....

{Morshchakova} I agree, but it is said with pride: we have managed to increase the material receipts of courts of general jurisdiction. It is sometimes lost sight of here that the magistrates' courts are for the citizens. Yes, the judges need to be supported, but not at the expense of the interests of the citizens. In actual fact, we need constantly to balance the system, to maintain the balance--checks and balances are needed: transparency of the associations, the compulsory publication of all judgments, the institution of proceedings against officials, and so forth. But the main idea of the reforms cannot be distorted. The sense of it is that there is a gigantic gap between the court and society, society's gigantic distrust of the courts. Society is unwilling to assume part of the responsibility for the courts: we simply have no trial by jury--the public element is not present in the courts. Society regards the court as an instrument hostile to its interests. But judicial authority, like any other, has to have a foothold in society. What, is it, then, fighting this society, perhaps? It should serve it, not be in a state of war with it. The constitution says that all that is accorded the citizens is supported by justice, and this objective is accomplished by the courts.

[Description of Source: Moscow Ekspert in Russian -- Weekly business magazine known for its reporting and analysis of financial-industrial groups and their political interests, partly owned by Vladimir Potanin.]

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# **EXHIBIT 21**

# Russia and the World Trade Organization

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the regions. As it was noted, the problem is that 'there are three systems that might hear similar disputes, the rate of development of precedents and predictability of the law will be retarded.'<sup>169</sup> But even in those cases where judicial decisions exist, there are serious problems with enforcement as voluntary law-abiding behaviour is rare and the state has not provided the institutions and rules which are necessary for enforcement of court ruling. However, as many business people confirm, the main difficulties in doing business in Russia 'are due more to uncertainty about government actions than contractual weaknesses.'<sup>170</sup> Russian administration works slowly, it is unpredictable and frequently corrupt. A comparative study indicated that 'it takes, on average, four times as long to set up a new business in Russia as in Poland, and that such businesses are subject to significantly more inspections and other cumbersome regulations.'<sup>171</sup> There are many examples of Western companies having avoided the Russian market or having slowed down their investments because of the weak legal system, the intrusive, unpredictable and corrupt nature of the administration and the court system. These weaknesses are to a very large extent responsible for the low level of foreign investments in Russia.<sup>172</sup>

The sharp increase of corruption and organized crime is probably the darkest side of the transition process. However, this is not to suggest that corruption did not exist in Russia in earlier times. In Tsarist Russia, officials were paid little and they were generally considered to be pervasively corrupt at all levels. Later in Soviet times, corruption was also widespread, but it took different less monetary forms, as cash, convertible currency and quality goods were in short supply. The size and depth of corruption, however, was strongly limited by the very strict control over all aspects of life exercised by the party and state apparatus. Of course, it is very difficult to compare the level of corruption before and after the introduction of major reforms. The result of a 1994 opinion poll indicated, however, that 47 per cent of the sample felt that 'bribery was more prevalent today' than during the Brezhnev period; '34 per cent believed that the respective levels were about the same, and only 4 per cent felt that Brezhnev-era bureaucrats were more susceptible to bribery than their present counterparts.'<sup>173</sup> All available information suggests that after the collapse of the totalitarian Soviet regime, Russia has become one of the most corrupt countries in the world. According to the index published by

'Transparency International', which ranked 52 countries, Russia was the 49th most corrupt country in 1997.<sup>174</sup> The Economic Intelligence Unit Risk Service which covered 97 countries, gave Russia and four other CIS countries the highest rating for corruption among public officials. The DRI McGraw-Hill Global Risk Service gave 12 CIS countries the average corruption score of 64 per cent, a level only slightly exceeded by the countries of sub-Saharan Africa.<sup>175</sup>

In Russia there are over one million bureaucrats who have been given, by laws and regulations, probably with the intention to create an environment susceptible to corruption, wide discretionary powers. This situation, together with the fact that wages and salaries in the public sector are at such a low level that it implies that officials, following old Russian traditions, are going to be 'fed by clients'. During the last few years of the reform process, substantial wage arrears being the rule rather than the exception in the public sector, has provided an extra incentive for corruption.<sup>176</sup> According to estimates, at least 70 per cent of all officials are corrupt. Commercial companies allocate from 30 to 50 per cent of their profits to bribe authorities. Some suggest that each official has his price. Expensive officials include those working in the banking and finance spheres, who have the powers to provide loans on concessional terms. According to the data provided by the Ministry of Interior, up to 40 per cent of a loan returns as cash to the pocket of the issuer. An especially dangerous development of the past few years is the growth of corruption among 'the political and even ruling élite'. This is a direct threat to the weak Russian democracy. Corruption is of special concern in the areas of law enforcement, customs and tax, and supervisory agencies. The quick mass privatization, as we saw earlier, has contributed to the criminalization of the economy.<sup>177</sup>

Corruption and organized crime support and feed each other. The extent of criminality and total disrespect for law has reached such dimensions that public perceptions concerning some basic elements of social relations have changed. According to an August 1997 poll, 52 per cent of the respondents to the question 'who do you believe runs Russia?', selected: 'the mafia, organized crime' as their reply. Only 21 per cent chose: 'state authorities'.<sup>178</sup> This public feeling precisely corresponds to the conclusions drawn by a recent study prepared by the Russian Academy of Science's Institute of Sociology which states: 'organized crime and corrupt government officials

control over 40 per cent of the Russian economy, including approximately two-thirds of all commercial institutions, 35 000 businesses, 400 banks, as many as 47 stock exchanges, and 1500 government-owned enterprises.' It was also revealed that 35 to 80 per cent of the shares in different financial institutions were controlled by Russian criminal organizations.<sup>179</sup> Most commercial undertakings have to pay 'protection money', ranging between 10 to 50 per cent of turnover to stay in business.

Crime and corruption has affected practically all segments of social, economic and private life. Public security has worsened dramatically, reflected especially in a very high homicide rate.<sup>180</sup> Even the payment of salaries is influenced by crime as, according to first deputy prime minister A. Chubais's estimation, embezzlement and financial manipulation by managers accounts for 'at least 50 per cent' of wage arrears nationally.<sup>181</sup> Tax evasion has become a national sport for both individuals and business entities. Copyrights, trademarks and other intellectual property rights are generally ignored. The International Intellectual Property Alliance estimated that 'nearly 100 per cent of videos sold in Russia are pirated and the Software Publishers Association estimates that the rate of piracy of computer software in Russia is 95 per cent.'<sup>182</sup> The whole society can be characterized by pervasive lawlessness and universal disrespect for legal institutions including courts and other legal procedures, 'regarding them as corrupt and arbitrary'.<sup>183</sup> As a result, 'Today a citizen, an entrepreneur, is compelled to equally protect himself against the violation of his rights both by criminal elements and by the state apparatus.'<sup>184</sup>

In summer 1999 reports revealed that Russian organized crime used a New York bank for laundering about US\$10 billion. Experts expressed concern that 'Russian criminality reaches the highest levels of government – is, indeed, often indistinguishable from it.' The fear was also voiced that the evil of organized crime, woven into Russian life, 'is starting to infect the rest of the world.'<sup>185</sup>

The Russian state does not fulfil its basic function in contract enforcement or in providing protection against criminals for individuals and business. What the state can not do, the mafia can, or at least makes an attempt to carry out. As a result, the mafia is heavily engaged in both contract enforcement and protection of business, demanding a high price for its services and forcing people to pay with

threats of physical harm or murder.<sup>186</sup> Of course, the observation that 'there are reasons to doubt that the Mafia will actually provide an efficient level of contract enforcement' is quite correct.<sup>187</sup> As President Yeltsin declared, the 'criminal world has openly challenged the state and launched into an open competition with it.'<sup>188</sup> The state's lack of action reinforces the feeling in business that tax evasion is the right thing to do as 'they are having to pay separately for services the state should provide.'<sup>189</sup> As the state does not fulfil its functions in the social sphere either, it is not surprising to find that the mafia also plays a role there. 'Membership of a gang can provide an identity, a place in a hierarchy, in a time of anomie and chaos. More importantly, they can offer security, not just for the moment, but also for old age... at a time when state pensions are almost worthless. In short, the Russian mafia is often seen not so much as a parasite but rather as vital.'<sup>190</sup>

### The role of regions

After seven decades of strong Soviet centralization, when frictions between vastly different regions and Moscow were suppressed by force, the period of reforms has brought decentralization into the relationship between the centre and the provinces. The 1993 Constitution defines Russia as a federation of 21 autonomous republics and one autonomous region, six territories (krays), forty-nine oblasts, ten autonomous districts (okrugs), and metropolitan centres (Moscow and St Petersburg). These 89 'federation subjects' form the intermediate level of government. Local governments (at county, city and village levels) are subordinated to the administration of these federation subjects. Differences between regions in terms of economic development, languages, religion or traditions are enormous. Controversies with independence-minded Muslim regions have taken the form of open wars, as demonstrated by the examples of Chechnya and Dagestan.

According to Article 71 of the Constitution, the exclusive jurisdiction of the Russian Federation includes the determination of the basic principles of federal policy and federal programmes in the fields of economy, environment and the social, cultural and national development of the Federation; establishment of the legal framework for a single market; financial, monetary, credit and customs regulation,

# **EXHIBIT 22**

## Corporate Governance Issues in the Russian Federation - What Investors Should Know

Market Infrastructure
Information Infrastructure
Problems of Financial Reporting
Legal and Regulatory Framework
Conclusion

In the months following the financial crash of August 1998 in the Russian Federation (Russia), corporate governance and the related issues of transparency and disclosure emerged as central concerns of investors in the Russian market. The new sobriety following the speculative "boom" years of 1997 and pre-August 1998 has meant an intense focus on existing corporate governance practices in Russia as a major impediment to improving the business climate. Highly publicized instances of shareholder-rights violations and abuses in the global and Russian media have only fueled concern that Russia's ability to attract both portfolio and strategic investors will be significantly handicapped unless there are extensive, practical efforts to improve the quality of corporate governance. International organizations and multilaterals, including the OECD, the International Bank for Reconstruction and Development, the European Bank for Reconstruction and Development, and others, have responded by placing issues of corporate governance high on the list of priorities to be addressed at senior levels in Russian government and business circles.

From the investors' viewpoint, risks associated with inadequate corporate governance standards of a Russian company necessarily should be viewed in the context of the country's market and information infrastructures, and legal and regulatory framework. This paper considers the evolution of Russia's market in the post-communist period, and the impact of various developments on corporate governance practices. The purpose of this work is not to provide a list of factual and potential abuses of shareholder rights in Russia, but rather to give an overview of the evolution of corporate governance practices in this country and to track the sources of current problems.

### Market Infrastructure

#### Historical legacy

The course of development of Russia's market infrastructure since the collapse of the Soviet Union has been profoundly influenced by the country's recent political and economic history. There is little in 20th century economic life in Russia that logically foreshadows the emergence of responsible corporate governance practices in the new terrain of post-communist Russia. Unsurprisingly, therefore, the challenges associated with building good corporate governance into the infrastructure of the country's marketplace are vast and daunting.

Russia's economy trailed its European neighbors in the several decades before 1917, evidencing weaknesses that ultimately led to political upheaval and revolution. In the 70-year period that followed, communist rule and its command system effectively destroyed all living memory of the workings of free markets.

Basic principles of private property, competition, share ownership, and other elements of a free market system were absent in Russia for roughly three generations. These concepts were generally alien, or at least ill regarded, in a regime characterized by state economic control and ownership, and centralized planning. Compared with countries in Central Europe, whose experience of a communist economic regime was considerably shorter, Russia's communist rule meant that there was little, if any, tradition of market economics that took root in the country's economic culture. Consequently, the disintegration of the Soviet Union left newly independent Russia with little in the way of a managerial, legal, or regulatory infrastructure to guide its transition.

#### Privatization

Privatization of state economic assets was a key priority for policymakers following the break-up of the Soviet Union in 1991. Even though Russia lacked the market infrastructure to accommodate a smooth privatization process, the urgency of creating a clear break from the past tradition of state ownership was paramount -- in part to ensure that there would be no reversal of course.

Because of political reasons, privatization provided significant privileges for insiders, both managers and employees. The law provided three basic opportunities of privileges for employees (the model was to be chosen by employees):

1. Model 1 Twenty-five percent of shares (all preferred), but not more than the equivalent of 20 minimal wages per one person were granted to employees; 10% of stock (all common), but not more than six minimal wages per one person were sold to employees with a 30% discount; management received an option for 5% of stock (all common), but not more than the equivalent of 2000 minimal wages per one person.
2. Model 2 Fifty-one percent of shares (all common) were sold to employees.
3. Model 3 Management received an option for 20% of common shares (execution of this option was subject to fulfillment of a business plan); and 20% of shares were sold to employees.

Three-quarters of Russian enterprises chose the second model of privatization, which provided for private placement of 51% of shares with employees.

Ultimately, significant ownership stakes in many state-owned firms were transferred from employees to company managers. Most of these managers -- who came to be known as "red" directors -- lacked incentives and the basic know-how required to launch reforms and industrial restructuring; as a group, they displayed little interest in or respect for their responsibilities to their boards of directors, minority shareholders, and other stakeholders. In many Russian firms, this situation has continued to the present day.

Even for those managers who recognized the potential economic benefits, the voucher system of privatization did little to encourage real industrial restructuring. The goal of the privatization program was a quick, massive transfer of ownership to private hands from the state. The process was not geared to attract new investors able and willing to provide infusions of capital and management know-how. And where investors did demonstrate an interest, managers with little motivation to surrender control and opportunities to build personal fortunes often rebuffed them. Consequently, governance of many Russian firms came to be controlled by insiders -- its managers -- with limited impact from outside shareholders or directors. This insider structure has given rise to many cases of abuses by firm managers accustomed to rewarding themselves at the expense of the firm's financial stakeholders.

#### **Financial-Industrial Groups**

In addition to these changes in management structure at the individual firm level, the organization of the Russian economy around financial industrial groups (FIGs) also significantly affected corporate governance practices at a broader level. The creation of FIGs in Russia recalls similar forms of industrial organization in Japan (*keiretsu*) and Korea (*chaebol*). The FIG structure also borrowed from the German model of market organization, in which banks and industrial corporations are closely allied through cross-ownership stakes and mutual support.

The rationale for the formation of Russian FIGs, drawing on what were perceived to be positive examples in other countries, was to provide a base of stability and cohesion to guide Russia's industrial and financial sectors through the challenging period of economic transition. At the same time, however, this structure also spawned new potential for managerial abuse. Relationships among firms within a FIG, its owners, and its managers have never been transparent. This is true not only in Russia, but also in other countries where similar forms of industrial organization exist. Murky ownership structures typical of Russian FIGs can facilitate governance abuses such as transfer pricing to related firms on non-market terms, asset stripping, share dilution, illegal capital flight, and self dealing. Also, abuses are particularly prevalent in environments such as Russia's where the legal framework, including both the quality and enforcement of existing law, is weak or still developing.

Russian FIGs as a feature of Russia's economic landscape came to prominence in the mid-1990s following the so-called "loans-for-shares" scheme in 1995. Under this government policy, Russian banks bought stakes of leading Russian companies at prices far below market value, or any reasonable fair value, creating a windfall for well-connected Russian entrepreneurs positioned to acquire large ownership stakes in Russian industry. It is widely understood that the results of the share auctions held to define the ultimate owners of share stakes had been predetermined and activated

through violations of the law by corrupt government officials. These stakes were acquired through FIG structures, leading to the rise at astonishing speed of the "oligarchs"--a small group of individuals controlling the leading Russian FIGs--who quickly amassed enormous personal wealth and economic power. In the public mind, FIGs and their leaders came to be associated with a brazen, unfair privatization process, benefiting an "inside" few at the expense of the country as a whole. The loan-for-shares saga also undermined efforts to encourage a culture of fair, free market management and corporate governance practices in Russia by seeming to endorse a business culture with limited respect for the rule of law and shareholders' rights. A business tradition of corruption, if not criminality, developed in its place. Indeed, in some circles the oligarchs are routinely characterized as "kleptocrats," who have produced nothing, invented nothing, and enriched no one but themselves through back-room deals.

### **Economic Stresses**

For those Russian firms attempting to build legitimate corporate enterprises, Russia's economic environment has been a source of significant stress in recent years, thereby creating further challenges for the establishment of healthy corporate governance. After the fall of the Soviet Union, industrial output dropped significantly throughout most of the 1990s, with the first signs of a return to industrial growth appearing only in 1999. At the micro level, high inflation, a weak currency, and poor fiscal management at the federal government level complicated the already difficult process of adapting industrial enterprises to compete effectively in a free market economy.

Even during the relatively buoyant period of 1996 and 1997 -- a time in which Russian enterprises were attracting considerable foreign investment in both the debt and equity markets -- many structural flaws were apparent. These included the inability of the Russian government to collect taxes; the common occurrence of both governments and enterprises not paying their workers or other creditors for their services; the relative absence of a cash economy; and the significant role in the economy played by barter. A significant part of the foreign investment was in the form of equity purchases in the secondary market rather than new issues, and thus did not entail capital infusions into enterprises. At the same time, much of the capital flowing into Russia wound up being re-exported in the form of capital flight, with many Russian entrepreneurs enriching themselves -- legitimately or otherwise -- with a predictable adverse effect on investment flows into the country.

These economic stresses, exacerbated by the Asian crisis and accompanying retreat of global investors from emerging markets, culminated in the Russian financial crisis of August 1998, when the Russian government simultaneously devalued its currency, defaulted on its domestic debt, and declared a moratorium on foreign currency debt payments by banks and subjects of the Russian Federation. Since that time, a period of relative stability has ensued, with a return to GDP growth beginning in 1999 spurred by higher oil prices and the positive effect of the ruble devaluation on the country's retail and export sectors.

Even as Russia's economic indicators have continued to surpass expectations in 2000, many of the macro and microeconomic reforms required to rectify structural flaws have not yet been instituted and there are some concerns that economic stagnation could lie ahead if the pace of structural reform slows. Thus, although improving, the difficult environment will continue to pose challenges to enterprises trying to establish a sound financial footing. Still, anecdotal evidence suggests that many firms that expect to participate in global financial markets are taking steps to restructure and improve internal efficiencies in order to increase their attractiveness to investors. As a part of this process, managers of the more progressive firms increasingly recognize the need to address transparency and corporate governance concerns of investors.

### **Political Environment**

The collapse of the Soviet Union and the assumption of power by President Boris Yeltsin put Russia on an early course of market reform conducive to the establishment of responsible corporate governance. Over time, however, the positive momentum of the Yeltsin government dissipated into inaction.

During the early years of the Yeltsin administration, market reformers held key governmental positions. However, attempts at reform were frustrated by the difficult economic environment, the dominance of the parliament (*Duma*) by communist and right-wing extremist groups opposed to market reforms, and the entrenched interests of the newly created wealthy elite.

The credibility of economic reform was adversely affected by the continued economic

hardship suffered by the majority of the population. International aid that was channeled through the government for distribution relied too heavily on the goodwill of certain personalities, leaving the distribution process exposed to theft and fraud. The link between the Yeltsin government and the leading FIGs further affected the credibility of many leading reformers—it was the Yeltsin government that sponsored the controversial loans-for-shares program in 1995 that resulted in a transfer of key state assets to the FIGs at virtually giveaway prices. This link was reinforced in 1996 when the "oligarchs" joined forces to promote the election campaign of Yeltsin in the face of strong opposition from the communists, thus associating the Yeltsin presidency with the FIGs and implying at least a passive government tolerance of the FIGs' often inequitable business practices. This highly visible political influence translated into immense financial and economic power for the individual oligarchs.

At the local government level in Russia, practices of corporate governance mostly have been determined by the economic behavior of local governors. The Russian Federation at the subnational level includes 89 "subjects" or local and regional administrations, and attitudes toward market reforms within these governments differ widely. In many cases, even those local governments pursuing some policies conducive to market reforms and healthy corporate governance have not been able to break the cycle of "offsets," or widespread nonpayments of companies to each other, with a resulting direct and debilitating effect on the health of local and regional economies. In many instances, subsidies and tax exemptions are used to keep afloat enterprises with federal, regional, or local government ownership stakes, even if their businesses are not financially sustainable. While local governments often cite the high social cost of shutting down unprofitable enterprises, it is also true that the murkiness of the system of non-cash payments makes it easier to hide fraudulent transactions and the siphoning off of assets by corrupt officials.

Yeltsin's successor, Vladimir Putin, was elected president on March 26, 2000, after encountering no serious opponents in the election process. The consensus backing Putin's victory included the belief that the Putin administration would be pragmatic, reformist in some areas, such as creating greater clarity in the legal code and enforcing court judgments, and responsive to concerns of foreign investors in sectors where attracting investment is a priority. All of these factors may support efforts to improve corporate governance practices in Russia. Putin emerged as victor with a singular opportunity to pursue real structural reform in cooperation with a more reform-minded Russian Duma elected in December 1999. The salient change was that the communists, reduced in number and with various splits among their ranks in the Duma after the December election, had lost their ability to obstruct presidential legislative initiatives.

Putin's first move was to strengthen federal power and to begin overhauling the state apparatus. The central thrust of this reform was to weaken the monopoly of regional governors, many of whom had become accustomed to governing almost as feudal lords—that is, as authoritarian leaders often disobedient regarding decisions of the federal government, and ignoring property and other rights which interfered with their political ambitions.

In May 2000, Putin signed a decree introducing a new system of seven super-regional administrative entities (*okrugs*) to consolidate operating, reporting, and financing of a number of federal services: the courts; the prosecutor general's office; regional departments for combating organized crime, etc. The *okrugs* are headed by "authorized representatives" appointed by the president. Notably, all but one of those selected for this new duty have a military background.

As a second part of the regional reform program, Putin passed through the parliament a regulation to reconfigure the composition of the Federation Council, the upper chamber of the Russian parliament. The new Federation Council would now be made up of elected senators, rather than the regional governors, signaling a new blow to the power of the governors.

In its economic policy, the Putin government appears to recognize the importance of increasing the competitiveness of the Russian economy and improving the country's investment climate. These goals became a cornerstone of the new economic program drafted by the team of Herman Gref, the minister heading the economic policy-making apparatus in the Putin administration, and were formally adopted by government resolution on July 27, 2000. Among other things, the program calls for an enhancement of the supervision of related-party transactions (the relevant bill should be considered by the Duma before the end of 2000), various improvements in the protection of investors' rights, and better enforcement of the rule of law. The new program also calls for the creation of a council of entrepreneurs to advise the government on improving business conditions in the private sector.

Passage of new tax legislation is another significant achievement of the Putin administration. The outdated Russian tax system, a Soviet legacy, has been poorly enforced and has engendered widespread tax evasion by individuals and enterprises. A package of amendments to Part 2 of the Tax Code, aiming to streamline tax collection procedures, reduce the tax burden (among other things, it establishes a flat-rate 13% income tax and regressive social tax), and increase the liability of delinquent taxpayers was successfully passed through the Duma and signed into law on Aug. 7, 2000. The new regulations will take effect in January 2001. Along with its tax reform program, the government has also tried to make clear, through a series of highly publicized interventions of the tax authorities at a number of the country's largest enterprises, its intention to take action against tax violators.

While the impact of the Putin administration's policies is not yet fully evident, some economists now predict that capital flight, which has been ranging around \$2 billion per month, will begin to lessen modestly, returning to levels seen in 1997 (\$22.4 billion) before the onset of the financial crisis in August 1998. At the same time, foreign direct investment is trending modestly upward, reaching \$1.8 billion in the first half of 2000, with a forecast of \$4 billion by year's end. Another positive indicator is the reduction in the level of barter transactions, down to 40% from more than 70% in 2000, and the replacement of mutual clearing and veksel settlements by cash transactions.

Nonetheless, in spite of these positive developments, political uncertainty remains a key issue in Russia. There is some concern, for example, that a broadened definition of state interest and the need for secrecy could reduce transparency in key industrial sectors. Other questions center on the Putin administration's commitment to freedom and independence of the press, and the participation of foreigners in Russian enterprises. While broad-scale renationalization is not expected, actions to consolidate state participation, particularly in defense industries, could spell problems for existing investors.

Although Putin's popularity ratings have suffered in recent months, he still enjoys wide popular support, even as recent polls indicate that most Russians believe Russia is becoming less democratic under his administration. In recent months, the Putin administration has taken a number of actions, which appear at best inconsistent with the aim of improving the country's investment climate. For example, a widely publicized action by the tax police (featuring armed men in black masks) against media oligarch Vladimir Gusinsky was perceived by many to be a crude attempt to stifle criticism of Putin on a leading TV station then part of the holdings of Gusinsky's company, Media-Most. In another example, the recent recall by the Ministry of Telecommunications of frequencies previously granted to two well-established Moscow-based cellular telecommunications services companies was widely perceived to be related to an inside deal involving licensing and operation of a third cellular operator which appeared on the market without a tender. The precipitous drop in the share prices of the two cellular companies and subsequent investor outcry appear to have thwarted the plan to recall the frequencies for the time being, but the final outcome is still unclear.

If Putin's popularity ratings should slide further, it may be more difficult for his administration to pursue the vigorous reform program outlined in the Gref plan. Also still unclear is the level of Putin's real independence from the entrenched interests of the former Yeltsin entourage ("The Family") and the oligarchs as a whole. At this stage, Putin also seems to be walking a fine line, trying to push ahead with reforms, but not wanting to endanger his relationship with various groups of hardliners - the military in particular.

#### **Market Institutions**

Standards of corporate governance practices in the Russian market are affected by the operating practices of key market institutions. The Russian domestic debt and equity markets are centered on the two main exchanges, the Moscow Interbank Currency Exchange (MICEX) and the Russian Trading System (RTS). While both MICEX and RTS survived the financial crash of August 1998, their operations were severely curtailed and trading volumes have yet to return to the highs of the "boom" times of 1997-1998. Both MICEX and RTS have made steady improvements in their technology and listing standards; MICEX, in particular, is working to incorporate corporate governance standards in its listing requirements and establish links with European exchanges.

Before August 1998, the debt market was dominated by federal government debt (GKOs), as opposed to private sector bond issues. After a lengthy hiatus, the federal government is beginning new, limited issues of debt, but appetite for these issues to date is small. While both shares and bonds are traded on the secondary market, new

# **EXHIBIT 23**



PDP/00/6

# IMF Policy Discussion Paper

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## Capital Flight from Russia

*Prakash Loungani and Paolo Mauro*

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INTERNATIONAL MONETARY FUND

## I. INTRODUCTION

Several years into its transition toward a market economy, Russia is still experiencing massive capital flight. The costs of capital flight are well known: they include a loss of productive capacity, tax base, and control over monetary aggregates—imposing a substantial burden on the public at large and rendering policy-making more difficult. Capital flight may also reflect and facilitate illegal activities, and there is a widespread perception that this is particularly relevant in the case of Russia. Finally, press reports abound on the possibility that part of the funds from the International Financial Institutions (IFIs) have been simply channeled out of Russia and even into individuals' bank accounts abroad. Therefore capital flight may also be undermining public support for the IFIs' programs in Russia.

The root causes of capital flight from Russia include an unsettled political environment, macroeconomic instability, relatively high and unevenly enforced tax rates, an insolvent banking system, and weak protection of property rights. These causes generate a flood of flight capital, which leaves the country through channels such as under-invoicing of export earnings, fake advance import payments, and bank transfers bypassing existing capital controls.

The Russian authorities have been seeking to limit capital flight through a two-pronged strategy. First, economic reforms, often under the auspices of programs supported by the IFIs, attempt to tackle the root causes of capital flight. Second, capital controls attempt to block particular channels of capital flight; efforts in this direction were stepped up in the aftermath of the August 1998 crisis.

This paper documents the scale of the capital flight problem in Russia, compares it with that observed in other countries, and reviews policy options. It finds that capital flight seems to have reached a historical high in Russia over the past couple of years. Russia's experience stands in sharp contrast to that of the advanced reformers in Central Europe and the Baltics in recent years, as well as that of Latin America in the early 1990s. In these cases, capital flight was curbed or reversed by a sustained improvement in macroeconomic performance or institutional reforms. Cross-country studies do not find evidence, however, that capital controls stem capital flight. Indeed, capital controls have clearly not been successful in preventing capital flight from Russia over the past few years, although they may have had some short-term impact in mitigating flight in the immediate aftermath of the August 1998 crisis (along with other developments such as the large depreciation of the ruble and some improvement in the fiscal balance). This paper argues that capital flight can only be curbed in a lasting manner through a medium-term reform strategy aimed at improving governance and macroeconomic performance, and strengthening the banking system; that capital controls result in costly distortions and should be gradually phased out as part of that medium-term strategy; and that, in the near term, the structure of controls ought to be simplified and rendered less distortionary.

## **II. THE EXTENT OF CAPITAL FLIGHT FROM RUSSIA**

This section provides estimates of capital flight from Russia, and places Russia's experience in context by comparing these estimates to those for other transition economies and other developing countries.

Capital flight is usually defined to include all outflows that occur in excess of those that would normally be expected as part of an international portfolio diversification strategy.

This definition includes outflows of funds originating from truly criminal activities; outflows of funds that are earned through honest activities, but are illegal in that they breach capital controls (or evade taxes); and fully legal outflows that comply with existing regulations and are motivated by a desire to flee the country owing to factors such as political uncertainty. The present chapter uses this standard, more encompassing concept of capital flight for two reasons. First, *all* capital flight imposes a burden on a country's macroeconomic performance. Second, using available data it is impossible in practice to distinguish among capital outflows that result from criminal activities, those that are illegal but originally acquired through non-criminal activities, and those that are legal. More generally, as there is no consensus on a single measure exactly pinning down the concept of capital flight, this note uses a number of measures to ensure that its main conclusions are valid regardless of the measure used.

Although all estimates of capital flight are tentative, capital flight from Russia seems to have been extremely high since 1994, averaging more than US\$20 billion a year (about US\$150 per capita) according to the "hot money" measure, and US\$15 billion (slightly above US\$100 per capita) according to the "broad" measure—two commonly-used measures of capital flight. Under the hot money measure, capital flight is defined as net errors and omissions in the balance of payments plus a subset of net private capital outflows. Under the broad measure, all net accumulation of foreign assets by the resident private sector is treated as capital flight.<sup>2</sup> The exact definitions are given in Box 1.

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<sup>2</sup> Sheets (1996) and Claessens (1997) provide a discussion of the various measures, their pros and cons, and references to the literature.

here as a summary statistic of the (lack of) success of reforms. Estimates at the quarterly frequency seem to be less reliable, but by some estimates (e.g., those by Westin, 2000), capital flight declined somewhat in the aftermath of the ruble's sharp depreciation beginning with the August 1998 crisis and the tightening of controls, only to pick up again as the world market price for oil increased.<sup>3</sup>

Not surprisingly, Russia's experience with capital flight stands in sharp contrast to that of the more successful transition economies (Figure 2). Following Fischer and Sahay (1999), the early reformers among the group of Central and Eastern European economies are defined to include Croatia, Hungary, Poland, the Czech and Slovak Republics, and Slovenia. Capital flight from this group averaged \$15 per capita using the "Hot Money 1" measure in the early years of transition, a far more moderate level than that experienced in Russia. Moreover, as reforms took hold and output growth resumed in these countries in 1993, capital flight reversed, with inflows averaging \$75 per capita during 1993-98.<sup>4</sup> Using the "Hot Money 2" measure, the extent of the reversal was even more pronounced, from flight of \$60 per capita to inflows of \$90 per capita. A similar qualitative pattern holds with the broad measure. The Baltics' experience is analogous (Figure 3). For these countries, there was

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<sup>3</sup> Another factor that can affect estimates of Russian capital flight is the investment in GKO and equity markets over the latter half of our sample period, particularly the large inflow during 1997. Anecdotal evidence suggests that a large part of the investment in these markets by purported nonresidents was actually by Russian residents who had previously taken capital out of the country. This suggests that the stock of flight capital waiting to return to Russia in the event of an improvement in the investment climate may be lower than would otherwise be the case.

<sup>4</sup> For the pre-1994 period, Sheets (1996) found that capital flight slowed or reversed in Poland, Hungary and (former) Czechoslovakia as reforms took hold, but continued unabated in Russia.

relatively small capital flight (US\$30-US\$40 per capita) in the early years of transition (1992-94), and capital flight reversed once growth resumed in 1995. The fact that Russia seems to be a special case among transition economies is confirmed by Garibaldi, Mora, Sahay, and Zettelmeyer (1999). They find that, considering the financial account as a whole for a broader set of transition economies, Russia is the only transition economy to have been a net exporter of capital over the past few years.

The extended period of capital flight in Russia is reminiscent of the experience of Latin America in the aftermath of Mexico's 1982 debt-servicing difficulties, which were followed by a decade of capital flight (Figure 4). While the level of flight was lower, on average, than currently in Russia, some individual countries did experience very high levels of flight. For instance, capital flight from Mexico exceeded \$250 per capita in 1983. The more recent crises in Latin America have not led to the same degree of capital flight, though here again the average conceals a fair degree of variation across individual countries.

### III. THE DETERMINANTS OF CAPITAL FLIGHT FROM RUSSIA

This section discusses the determinants of capital flight from Russia, making a distinction between the *root causes* of flight and the *channels* through which flight occurs.

#### *Root causes of capital flight from Russia*

Since the onset of the transition process, Russia has been struggling with a number of problems that make it risky for residents to hold their savings in the country and provide strong incentives to send savings abroad. These problems include the following.

- Macroeconomic instability, due in large part to an unsettled political environment, has caused uncertainty about the future returns on investment within Russia.
- Relatively high and unevenly enforced tax rates encourage tax evasion; funds are sent abroad to keep them hidden from the tax authorities.

form of tax advantages, investment or exchange rate guarantees, and priority over resident claims in the event of a financial crisis).

On the basis of the cross-country evidence, it is less clear, however, whether capital controls are effective in stemming capital flight. The majority of existing studies suggests that controls on outflows—and in particular, quantitative controls on outflows—have been largely ineffective.<sup>11</sup> In a panel of industrial and developing countries, Johnston and Ryan (1994) do not find evidence that capital controls were effective in insulating developing countries' balance of payments. Schineller (1997b) finds that capital controls have no impact on capital flight, controlling for fiscal imbalances and the presence of an IMF program. While in a few cases controls may be effective for a short time, soon investors learn how to circumvent them.<sup>12</sup> In addition, in many countries there seems to be a tendency for capital controls to become permanent, and this seems likely to happen in Russia as well.

## V. POLICY MEASURES

The root causes of capital flight in Russia seem to include uncertainty over policies, the confiscatory nature of the tax system, the banking system's weakness, and the unusual power of vested interests related to the energy sector. While the problem of capital flight is unlikely to be resolved in the short run, the experience of other transition countries shows

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<sup>11</sup> Dooley (1996), Eichengreen, Mussa and others (1998), and Edwards (1999) provide reviews of existing studies, and Ariyoshi et al. (2000) survey a number of recent country experiences.

<sup>12</sup> At present in Russia it seems that capital controls are less effective in preventing capital flight originating from vested interests in the energy sector, and more effective in keeping in check flight from the more reliable banks, consistent with the presence of excess liquidity in the banking system.

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that a few years may be sufficient to attain a turnaround in capital flight if progress is made in eliminating its root causes through ambitious reforms aimed at strengthening the banking system, improving the tax system, promoting good governance, and keeping vested interests in the energy sector in check.<sup>13</sup> Although these are difficult reforms, the capital flight problem will likely persist as long as its root causes are present.

In an attempt to stem capital flight, the Russian authorities have introduced a number of exchange controls.<sup>14</sup> Although multiple exchange rates were eliminated in 1993, considerable effort was devoted to the control of foreign trade in the initial stages of transition. In 1992-93, the authorities established and subsequently tightened a system of licenses for exports of "strategic" (raw) materials. In 1993-94, they set up a requirement for "transaction passports" providing the details of export transactions and, later, "export certificates." In 1995, trade was liberalized considerably, notably with the elimination of export quotas on most goods, leading to Russia's acceptance of the obligations of the IMF's Article VIII in 1996.

Capital controls were relaxed considerably in 1997, and by mid-1998 nonresidents were able to repatriate the proceeds of their investments in Russian securities. Capital controls were, however, reinstated and strengthened in response to the August 1998 crisis.

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<sup>13</sup> Specific suggestions are provided in a number of papers presented by other authors at the conference on "Investment Climate and Russia's Economic Strategy," Moscow, April 2000.

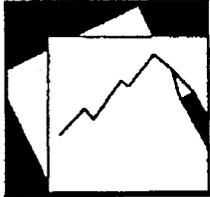
<sup>14</sup> A detailed chronology of changes in the exchange system is available in IMF (1999a) and IMF (1999b). The latter also provides the full status of exchange arrangements and exchange restrictions as of January 31, 1999. Russia's experience with capital controls is also reviewed in Ariyoshi et al. (2000).

The requirement to surrender export proceeds has also featured prominently among the measures introduced by the authorities. Beginning in July 1993, all Russian exporters have been required to exchange 50 percent of their hard currency earnings into rubles. That proportion was increased to 75 percent in January 1999, and a further increase to 100 percent has been considered.

All these exchange controls may have brought benefits, in the form of (temporarily) lower capital flight but, some authors have argued, also costs in the form of greater corruption and lower economic efficiency. The controls have created economic rents, and many resources are spent circumventing the controls to capture those rents. To the extent that enforcement is subject to bureaucratic discretion, this provides scope for corruption. Indeed, there is evidence of a significant association between corruption and capital controls in a cross section of countries (Box 3). Finally, not all firms are equally able to circumvent the controls, which contributes to uneven competitive conditions and distorts resource allocation. Tikhomirov (1997) argues that as controls were extended to more and more areas of the Russian economy, so did corruption. In his view, the system of export licenses nurtured the corruption of bureaucrats; later, the requirement that banks certify the accuracy of the transaction passports caused the spread of corruption to the banking system as well.

A precise cost-benefit analysis of controls in these terms is not easy. The costs resulting from higher corruption are difficult to quantify. The benefits in the form of reduced capital flight are similarly unclear, because it is difficult to estimate to what extent capital flight would have been higher in the absence of controls. However, in light of both international experience and developments in Russia it seems that capital controls are

# **EXHIBIT 24**



WP/00/30

# IMF Working Paper

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## The Transition Economies After Ten Years

*Stanley Fischer and Ratna Sahay*

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INTERNATIONAL MONETARY FUND

considered separately) clearly reveals the success of the CEE and the Baltics, particularly the latter, in systematically attracting inflows over time.<sup>21</sup> While no data is available for Russia prior to 1994, its situation stands out (Figure 7b): Russia is the only country that on a net basis exported capital throughout the transition period.

The composition of inflows, on the other hand, shows some similarities across countries (Figure 8). Long-term inflows have been significantly higher than short-term inflows. In addition, there was a large recourse to exceptional financing (defined as debt forgiveness, restructuring, official aid) at the beginning of the transition period and a subsequent reorientation of capital flows towards FDI and other private flows. This validates the notion that provided reforms were implemented, official assistance could speedily be replaced by private sector inflows.

Taking stock, large external assistance that was expected to finance the reform process did not materialize. Instead, technical assistance combined with limited new official aid was given. Over time, private flows began to trickle in but became significant only in a limited set of countries in the CEE and the Baltics, those that seemed to have the best records in the speed with which reforms were implemented.

#### **D. Implementation of Reforms**

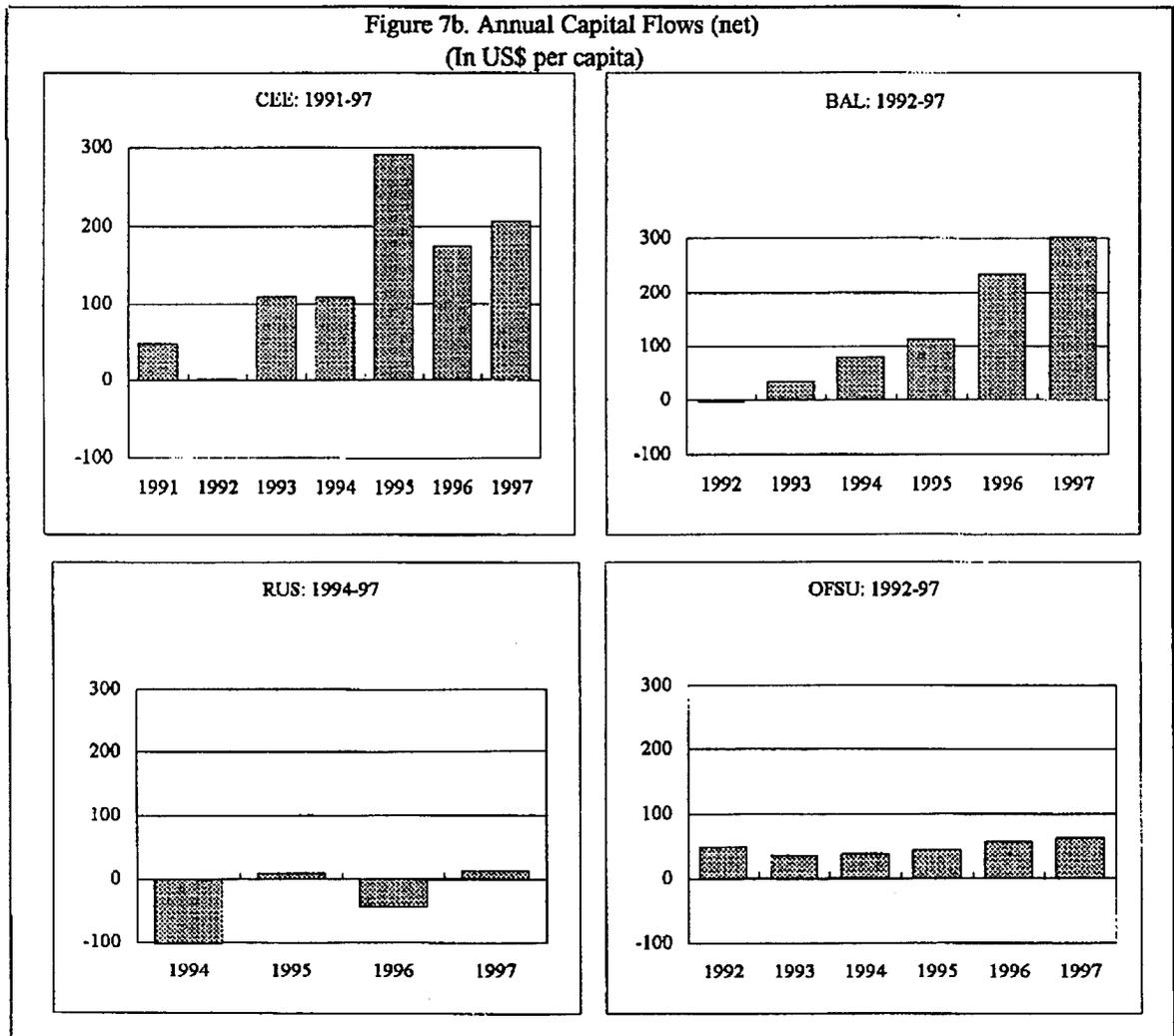
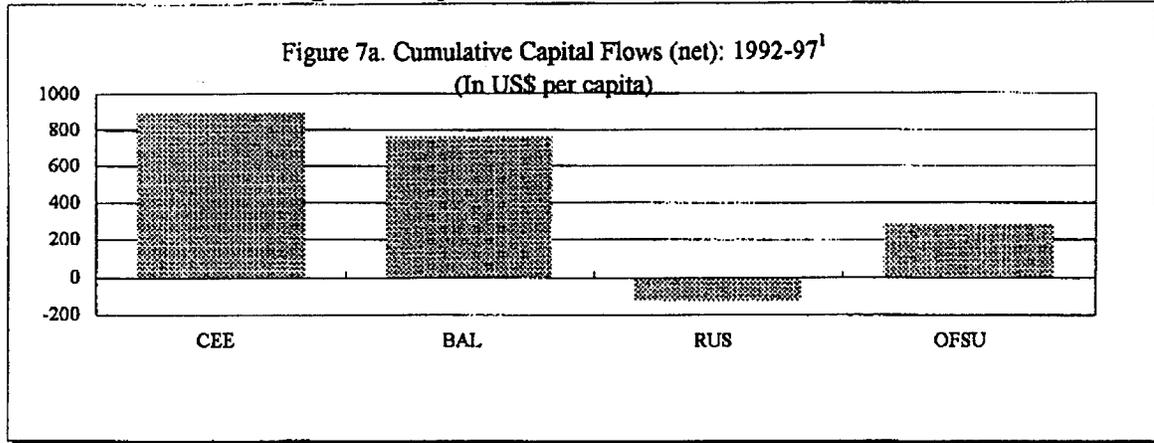
Many authors (Aslund et al., 1996, Sachs, 1996a, Stiglitz, 1999, Linn, 1999, Wyplosz, 1999, EBRD Transition Report, 1999) have recently sought to summarize the extent of policy change since the start of the transition process. In presenting inflation outcomes and fiscal data in Figure 4, we have summarized progress in macroeconomic stabilization. To measure the extent of structural reforms, we rely on information provided by the EBRD and computed as indices by De Melo, Denizer, and Gelb (1996). These indices are presented in Table 4 and graphed in Figure 9.<sup>22</sup> Three indices are monitored over time: the LIP which measures the extent of privatization and financial sector reforms, the LIE which measures the extent of the market-oriented reforms of the external sector, and the LII that captures the degree of internal liberalization of prices and market, including the extent to which competition exists in the economy. LI, the overall liberalization index, is computed as a weighted average of the three: LIP is given the highest weight (40 percent), while the other two are weighted equally. The highest value that any of these LI measures can take is unity; a value of one indicates the levels in matured market economies. We also present the CLI index, (for each year it is the sum of LI's to that point, starting in 1989), which is a variable reflecting both the speed and the level of reforms to date.

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<sup>21</sup>The case of Russia was so different from all other countries that for analytical purposes, it was considered as a group of one by Garibaldi *et al* (1999).

<sup>22</sup>These have been updated by Berg, Borensztein, Sahay, and Zettelmeyer (1999) for 1996-97.

Figure 7. Capital Flows in Transition Economies

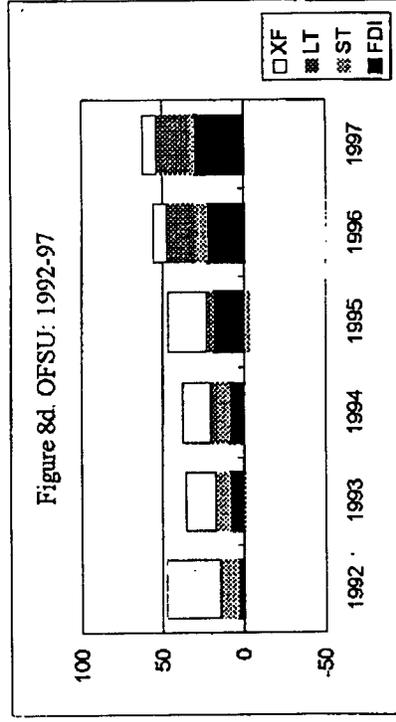
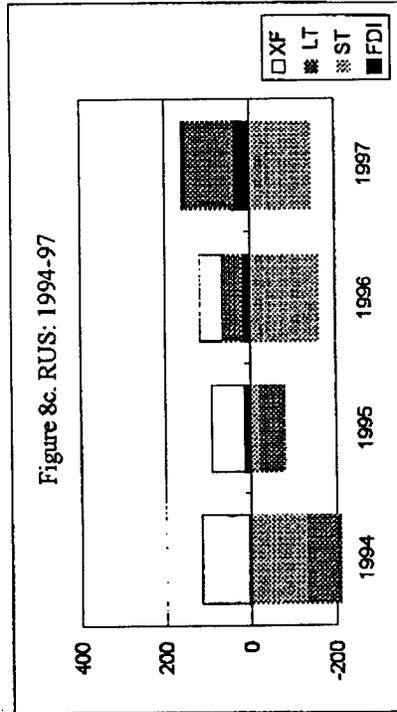
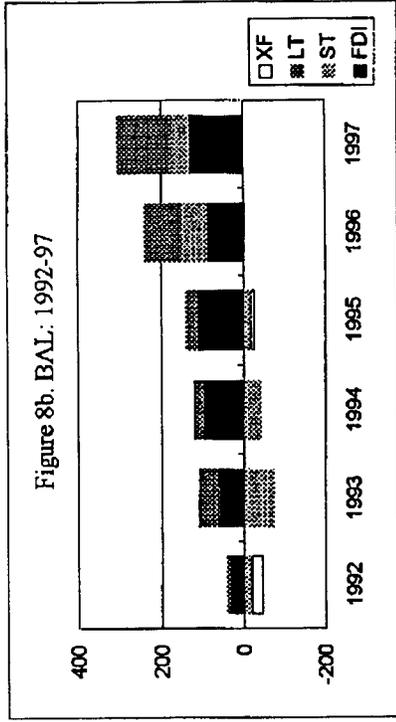
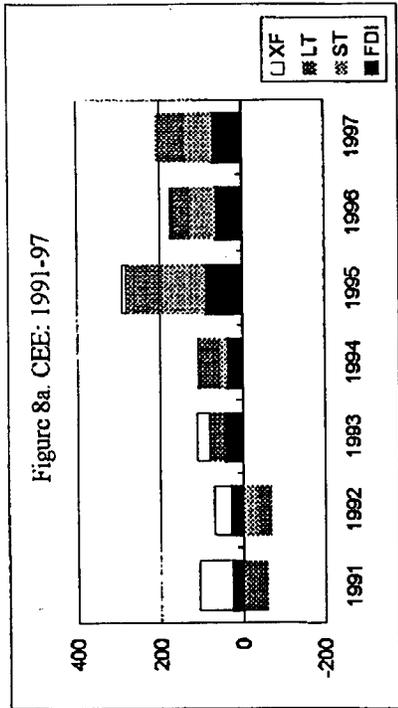


Source: Garibaldi, Mora, Sahay and Zettelmeyer (1999).

<sup>1</sup> For Russia, the period covered is 1994-97.

Note: CEE denotes Central and Eastern European countries, BAL denotes the Baltic countries, RUS denotes Russia, and OFSU denotes the remaining countries of the former Soviet Union.

Figure 8. Composition of Capital Flows  
(in US\$ per capita)



Source: Garibaldi, Mora, Sahay and Zettelmeyer (1999).

Note: CEE denotes Central and Eastern European countries, BAL denotes the Baltic countries, RUS denotes Russia, and OFSU denotes the remaining countries of the former Soviet Union. Also, XFI is exceptional financing, LT is long-term flows, ST is short-term flows, and FDI is foreign direct investment.

# **EXHIBIT 25**

DIALOG(R)File 484:Periodical Abs Plustext  
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03953363 (THIS IS THE FULLTEXT)

**Russian robber barons stash billions off-shore**

Sieff, Martin

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ABSTRACT: The bankers and organized **crime** groups responsible for Russia's economic collapse have stashed billions of dollars in secret **offshore** currency accounts. The **capital flight** out of Russia dwarfs international bailouts.

TEXT:

Headnote:

Bankers and organized crime groups have plundered Russia of resources and capital. Experts believe the billions siphoned from the economy dwarf International bailouts.

The men responsible for Russia's economic collapse have stashed billions of dollars in secret offshore currency accounts, burning Western investors and hurting their fellow countrymen. New York analysts estimate Western investors lost \$33 billion during a recent two-week period; European experts believe George Soros' group alone lost \$2 billion.

Institutions have published dismal projections of losses for the current tax year. Britain's powerful Barclays Bank estimates the Russian collapse will cost it at least \$225 million. US-based Bankers trust put its thirdquarter losses at \$350 million, the same amount forecast by Japan's Nomura Securities.

Even the most conservative analysts put the **capital flight** out of Russia between \$25 billion and \$50 billion during the seven-and-a-half years since the collapse of communism, according to Marshall Goldman, director of the Russian Research Center at Harvard University. These figures are near to or far higher than the International Monetary Fund, or IMF, support for the Russian economy during that time, which comes to \$31.6 billion, including \$4.8 billion sent since July.

Russian officials have said the real extent of the **capital flight** could be as high as eight to 10 times cautious Western estimates. Former interior minister Anatoly Kulikov said his department estimated that as much as \$300 billion had been siphoned out of Russia since 1992, nearly 10 times the total IMF aid to Russia and roughly four times the total international financial support. And it is three times **Russia's** total foreign debt, estimated by former prime minister Sergei Kiriyenko at around \$100 billion.

The billionaire bankers and organized-**crime** chiefs who seemingly have plundered **Russia's** immense resources and wealth have their profits safely hidden far outside the borders of their country, stashed in secret **offshore** tax havens. The men responsible fall into two overlapping categories, experts say: the handful of billionaire-banker barons who had monopoly control over the raw materials and factories of Russia during the last seven years (mainly during the five-and-a-half years Viktor Chernomyrdin was prime minister, from December 1992 to March 1998) and organized-crime groups that, according to former first deputy economics minister Vladimir Panskov, have exported at least \$250 billion in profits from Russia.

Many analysts have compared Russia's new billionaire bankers to the so-called "robber baron" industrialists of 19th-century America's so-called Gilded Age. But Frank Cilluffo, head of the task force on Russian organized crime at the Center for Strategic and International Studies, believes this description is unfair to the American robber barons.

"Our robber barons built real wealth," says Cilluffo. "They built real railroads, steel mills and auto plants, and then they built schools, libraries and hospitals out of the profits they made. The Russian oligarchs just plunder their own resources and send the money abroad straight into their overseas bank accounts."

(Photograph Omitted)

Captioned as: Ruble n Former prime minister Kiriyenko, right with IMF's John Odling-Smee on a loan installment

(Graph Omitted)

Captioned as: RUSSIAN SHELL GAME

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DESCRIPTORS: Finance; Economic conditions; Banks; International banking; Foreign aid; Organized crime

GEOGRAPHIC NAMES: Russia

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