Analyzing Russian compliance with anti-money laundering and combating the financing of terrorism, insider trading and anti-corruption laws

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Abstract

Purpose – The purpose of this study is provide a critical overview of compliance with anti-money laundering and combating the financing of terrorism, insider trading and anti-corruption laws in Russia.

Design/methodology/approach – The mixed approach for this article will be used with some elements of grounded theory. The method used includes the following: observations, various interviews and analysis of legal documents and other primary sources.

Findings – Russian regulatory compliance has a tremendous pressure and significant challenges for both regulators and regulated banks and organizations. It is a moment when Russia could become a more developed country and play a bigger role in international arena or come back to the past time.

Originality/value – The article is based on my practical experience and PhD research observations.

Keywords Russia, FATF, Anti-money laundering and combating the financing of terrorism, Insider trading and anti-corruption laws, CBR regulations

Paper type Viewpoint

Believe nothing, no matter where you read it, or who said it, unless it agrees with your own reason and your own common sense.

Buddha

Introduction

For some time, I have been intrigued by the apparent failures and breaches in the financial regulation within Russian financial services and in other parts of the world. A central part of compliance job is to understand the internal business processes, the regulatory and political environment and to carefully interpret the requirements of the regulator (state) while remaining fully aware of our business interests.

Having in mind that Russia joined the World Trade Organization (WTO) in December 2012 and so became a legitimate part of the global community and international trade, Russia is expected to align its laws and regulations with international standards. For example, decision processes should be more transparent and to not arbitrary or unfairly prejudice the interests or either business or the state. The development of compliance in Russia could act as a bridge drawing in Western

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standards that moderate Russian practices and so play a vital role in the development of Russian financial services.

In this article, three core compliance areas will be thoroughly discussed within the Russian regulatory context, such as: anti-money laundering (AML), anti-corruption and insider trading. I hope that my contribution will play some small part toward policy development and/or firm strategies with respect to the three abovementioned areas.

Overview of the compliance development in Russia

Compliance is not a separate phenomenon and has its own driving force and influencers. There is some macro-influence on shaping compliance vectors in the Russian financial institutions coming from the international agreements, treaties and international organizations. It is worth to notice that influence from the international standards and best practices have also the capacity to shift the balance of power (e.g. toward company interests or toward societal interests). The term compliance was initially introduced in Russia by the Central Bank of Russia (CBR) in 1999[1]. On February 15, 2004, this instruction was abolished, and the word "compliance" left the legislation along with it. However, despite the absence of the "compliance" concept in the Russian legislation, the Russian regulators require in practice such function in certain areas, such as anti-money laundering (AML) and combating the financing of terrorism (CFT) and countering misuse of information and market manipulation. Additional compliance regulations do also apply to professional players and assets management companies, insurance companies, specialized depositaries and non-state pension funds.

As for now, compliance has risen up the agenda of the Russian regulatory development due to the fact that the country seeks to actively integrate itself into the international arena. The key areas of concern are business behaviors and ethical business, arbitrary laws, efficiency of anti-corruption and insider-trading laws, AML and combating financial crime and issues of corporate governance. The most pressing provisions of international compliance regulation include the Foreign Corrupt Practices Act, UK Bribery Act, the Sarbanes–Oxley Act (SOX), the Dodd-Frank Wall Street Reform and Consumer Protection Act do have a significant impact on only compliance standards of big international companies located in Russia and Russian publicly listed companies. One of the major drivers for compliance development in Russia is the international agreements and treaties, as well as the requirements of international and intra-national organizations, such as Financial Action Task Force (FATF), The Organisation for Economic Co-operation and Development (OECD), WTO and Basel 2/3. International organizations, such as FATF imposes certain criteria with regard to AML and anti-corruption measures, which are subject to implementation into the Russian legislation. In practice, international organizations such as FATF imposed certain criteria with regard to AML/CFT and anti-corruption measures, which are then implemented into the Russian legislation and regulations (www.imf.org/external/pubs/ft/scr/2012/cr1253.pdf). As one example, the CBR Regulation N375-P dated March 02, 2012, which came into force on April 29, 2012, prescribing that banks have to adjust their AML/CFT processes and systems to new requirements has been adopted. The key component of this Regulation is the requirement for the financial institutions to apply a risk-oriented approach, while monitoring money-laundering activities of their clients, with special attention to off-shore companies and ultimately the beneficiary owners. All banks were required to comply before April 29, 2013, and to provide the CBR with

evidence of relevant changes made on their AML/CFT systems and procedures. Afterwards, the Russian Federation is supposed to make a report to FATF by mid-2013 on realization of the action plan. The consequences of these drivers are changes in legislation and raising responsibility of the management and compliance officers of the Russian companies and financial institutions. Therefore, Russia could become more developed country and play a bigger role in the international arena.

As one of the direction toward emerging focus on compliance is an official appointment of financial mega-regulator. Starting from the September 1, 2013, the CBR will have the powers to maintain vigilance over both banking and non-banking sectors (insurance companies, pension funds, brokerage companies, asset management companies and micro-finance organizations)[2]. The new regulator's employees will be full-time professionals appointed by the Government. It may be assumed that the approach of new banking regulator will be changing. Looking back, there was no conceptual understanding of what the regulators should do. There was no clear philosophy of the banking regulator, and we have to see whether the new mega-regulator since September 1, 2013, will change the situation. The previous regulator's strategy had a formal and rigid approach which did not correspond with the international practices and expectation, and moreover, did not respond to the purpose of their creation.

The question of the regulator's efficiency and responsibility remains an issue. There was no efficient system of internal control within the Russian regulators. Nobody being a state authority was responsible for any inefficient projects and dull regulations or requirements. There was no directors and officers insurance for the state authorities that means that in such environment there is no accountability of the state toward the business and individuals. In comparison, in the UK ACCE standards, there were no signals toward moving into this direction. On the contrary, the CBR is famous for its formalistic and old-fashioned approach and could cause difficulties in implementing quick and effective procedures required by the international and intra-governmental organizations. One of the biggest challenges is a tough consideration whether the new Russian banking regulator has taken the similar approach by enforcing its powers to the state, private and foreign financial institutions in Russia. The Russian version looks good on paper, but it remains to be seen whether the idea will work.

Review on AML

There are numerous bodies involved in the AML/CFT system in Russia that include the Federal Financial Monitoring Service (Rosfinmonitoring), the CBR, General Prosecutor's Office, Ministry of Internal Affairs, Federal Security Service, Ministry of Finance, Ministry of Justice, Federal Customs Service, among others. Therefore, the AML/CFT legislation designates Rosfinmonitoring as the body responsible for coordinating of the activity of other bodies with AML/CFT. In practice, coordination of AML/CFT activity of supervisory bodies takes place parting the framework of the AML/CFT Interagency Commission, which includes representatives of state authorities and representatives of self-regulating organizations. Despite the number of the state bodies involved in the AML/CFT process, the efficiency of the AML/CFT state control is quite low. Comparing to the US high standards while doing know your customer (KYC) or identification of the clients and nature of their assets, in contrast there is a quite formal approach of the Rosfinmonitoring to conduct an annual check of the Russian

financial institutions and to maintain the required level of the AML compliance. Therefore, the AML Law is working at a very formal and inefficient manner.

Starting from 2001, when Russia accepted to the Wolfsberg Principles on AML/CFT, the Russian Government has successfully spread awareness of AML/CFT in its financial sector[3] and has weeded out non-compliant financial institutions[4]; however, significant discrepancies still remain between the standards of international and local domestic banks[5]. There is a slight sign that the financial regulator in some areas (AML/CFT) keeps changing its attitude toward more professional compliance judgment (suspicious transactions in AML/CFT). In general, the regulator's strategy is getting more demanding and enhancing the role of compliance, more strict requirements toward people, systems, processes and IT. The shareholders confidence can be getting with the assistance of compliance, as compliance lives inside the processes and procedures. Russia operates within the rules-based environment, which means that each regulator tells what and how the regulated companies should do. As a result, the Russian financial organizations have to fulfill various formal requirements, e.g. to submit daily reports on obligatory transactions, which fall under certain criteria. The amount of such reports could vary from 1,000 to 10,000 obligatory transactions per day. Therefore, every financial organization in Russia has to keep adequate number of employees to be formally compliant with the AML/CFT Law requirements.

The FATF rules and KYC guidelines are well and good, but sometimes lack granularity. One of the major changes aimed to strengthening measures to combat money laundering has been introduced by recent Federal Law (the AML/CFT Law)[6]. Many provisions came into force on the official publication of the AML/CFT Law on June 30, 2013. The remainder will come into force between July 30, 2013, and January 1, 2015. This law is generally consistent with global trends of increasing government control over financial flows, in general, as well as the tightening of measures aimed at improving the transparency of financial transactions and increasing fiscal control. Insurance brokers, fund associations, non-state pension funds and telecom operators providing mobile radio/telephone communications services have been added to the list of legal entities subject to the AML legislation. One of the main challenges for the Russian banks is now the requirement to undertake measures to identify the beneficial owners of legal entities prior to accepting them as clients. For this purpose, a "beneficial owner" is defined as an individual who ultimately, directly or indirectly owns more than 25 per cent of the capital of the legal entity (which may also need to be the largest individual interest) or has the ability to control the actions of the prospective client. In practice, the regulated banks and companies are facing with a lot of challenges to comply with these requirements. Firstly, the AML/CFT Law was introduced at the date of its signing; therefore, the financial institutions did not have time for a proper implementation of new requirements into the internal processes and procedures. Secondly, the definition of the beneficiary owner of the client is rather vogue and arbitrary and there are no yet official recommendations or guidelines on how to comply with the requirements of new AML/CFT Law. There are no legal grounds stipulated by the AML/CFT Law under which the banks could in case of suspicious client refuse to proceed with payments or refuse in opening accounts. However the sanctions imposed for violation of the AML/CFT Law are approximately 0.5 million rubles (approximately 10,000 GBP) and there is no moratorium for introduction of such penalties irrespective of the significance of new requirements.

Review on insider dealing and market abuse

One of the most controversial Russian law is the Federal Law "On Counteracting the Abuse of Inside Information and Market Manipulation" (the Insider Trading Law)[7] that was published on July 2010. The provisions relating to the developments of internal procedures by insiders become effective from January 27, 2011, and the bulk of the provisions became effective on July 30, 2011. The provisions about criminal liability become effective on July 30, 2013. The adoption by the regulator of the Insider Trading Law can be considered as another step in bringing Russian financial service legislation in line with the world's main financial centers. It increases transparency in the Russian financial market and was aimed to level the playing field for all market participants. Although, it is not entirely clear how certain provisions of the Insider Trading laws shall be applied, as they required by the regulatory bodies. The Federal Service for Financial Markets has been merged into the CRB since September 1, 2013. Taking into account more political weight and right to legislative initiative some areas on inside law may be further developed. For instance, as the potential investors do not fall into any of the categories of persons to whom Insider Trading Law permits disclosure of non-public price-sensitive information, the disclosure of such information would violate the Insider Trading Law and would disqualify them form purchasing the securities. Although, it is still not clear how certain restrictions on disclosure of non-public price-sensitive information apply in practice, as it may seriously jeopardize the pre-offering marketing by Russian issuers. Moreover, the Insider Trading Law does not consider as inside information:

- information which has been disclosed to the public;
- research, forecasts, estimates and recommendations in respect of financial instruments, foreign currency and commodities; and
- offer to enter into a transaction involving financial instruments, foreign currencies or commodities.

Now, the CBR will have to develop and approve the timetable and procedure for the disclosure of inside information by primary insiders and by rating and press agencies. As a practical point, the CBR has yet to clarify whether to include a person in the insider list, such persons should have actual access to insider information or a mere ability to obtain such information. Furthermore, the Insider Trading Law does not recognize the concept of information barriers, or Chinese walls, to limit information exchange within an organization. This raises serious problems in respect of information exchange within legal entities, particularly financial institutions that provide financing, investment banking and other services to publicly traded companies or as a part of their treasury operations. If one department comes into possession of insider information about publicly traded company, and another department of the same financial institutions independently enters into a trade in respect of the securities of such company, such institutions will a breach of the Insider Trading Law. Also, it is not clear whether the requirement of the Law apply to foreign companies that gain access to information directly from primary insiders. Moreover, there is no clear guidance of the Insider Trading Law, as to what constitutes an engagement by a foreign company into legal relations in Russia. Therefore, it could be assumed that by appointing a new regulator a formal, passive and rather reactive position of the former regulator will be completely

changed. When new guidelines, recommendations and interpretation of the Insider Trading Law will appear, the strategy of new regulator will become more transparent and clear, especially taking into account that the Insider Trading Law made a difference for the Russian financial markets.

Review on anti-corruption

There is no country in the world which does not operate with bribery and corruption as criminal actions on its lawbooks (Noonan, 1984, cited Martin *et al*, 2007). Although many countries have formal statutes, they are seldom enforced (Sanyal, 2005); however, economic and cultural factors are of more importance than legal statues when assessing the extent and impact of bribery on a country. Sanyal (2005) undertook a similar study, with results and recommendations. He argued that there are three determinants of bribery in international business: *economic, cultural and legal.* Utilizing economic data obtained from the World Bank, he examined CPI scores for 47 countries reported by Transparency International, and found that in economic terms, corruption was more likely to be prevalent in countries with low per capita income and lower disparities in income distribution. In cultural terms, high power distance and high masculinity were likely to be associated with high level of bribe-taking. He concludes that because cultural values are deeply embedded and difficult to change, efforts to address bribery are likely to be long-drawn and frustrating, and that a legal approach is unlikely to be effective, but the measures have to be complemented by economic development with gradual cultural adjustment.

A practical example of Sanyal's conclusion in relation to anti-corruption efforts and approaches might be made looking at the efforts of the Russian Government against the corruption and the Turkish government. Russia and Turkey are very similar in many aspects. The first aspect is similar political culture and political governance, second similarity lies in a quite unique combination of the European and Asian methods of governance and thirdly in Turkey and in Russia the fundamental roots for corruption lie in the structure of public sector and the way in which these factors shape incentives and the broader behavioral environment. Therefore, the corruption aspects are historically contemporary challenges for these two countries. During the recent years, the Turkish government has addressed the issue of corruption through a series of reforms promoted in close linkage to the Turkey's European Union accession process. A first "Action Plan for Enhancing Transparency and Improving Good Governance in Public Administration" was issued in 2002. A "Commission for Enhancing Transparency and Developing Efficient Public Governance in Turkey" was established to arrange the preparation of strategies, plans, programs and other necessary activities for enhancing transparency and reinforcing the fight against corruption and to determine the general principles regarding activities carried out and measures that need to be taken. A new set of anti-corruption reforms was planned in the 9th Development Plan covering 2007-2013, adopted by the Turkish Grand National Assembly in June 2006. The package included the short-term priorities of the government concerning the enactment of legal instruments to better prevent and combat corruption.

The causes and sources of corruption in Russia are numerous. Firstly, a different cultural outlook on ethics and morality has developed at the governmental level when compared with much of the broader international community and this is amplified in case of Russia by the absence of democratic tradition. Secondly, Russia tends to

specialize in the production of goods and services located in the sectors of economy which is most vulnerable to bribery and corruption (for example, fossil fuels). Knowing the situation, former President Medvedev started in 2008 a series of systemic reform, but Russian anti-corruption law is very modern. Now, for example, sanctions for government officials who are caught engaging in official corruption are much higher. Russia has taken a step-forward by penalizing corporations, as opposed to just individuals, for corrupt acts. Four years later, former President Dmitry Medvedev admitted in his interview with the newspaper "Vedomosti" the failure of his anti-corruption policy and the absence of any successes in this area. The only serious achievement he mentioned was the adoption of anti-corruption legislation in Russia. But even this accomplishment raises severe doubts if we take into account the fact that the implementation of many Russian laws in practice leads to the opposite of the intended effect. In fact, in many cases, anti-corruption efforts do not have the intended effect. For example, in trying to exert maximal control over business and minimize the ability of bureaucrats to intervene, the state has created extremely complicated bureaucratic procedures that waste large amounts of time. These new regulations have stimulated companies to try to reduce the bureaucratic red tape they face through informal agreements with bureaucrats, thereby creating new corrupt practices. Reducing corrupt practices in one area has simply encouraged their growth in another. Russia has not yet applied in full international concepts when localizing international regulatory initiatives, and differences in the actual content of requirements has resulted in confusion. Therefore, the anti-corruption legislation currently in force does not have any requirements as to the creation of an internal control system, or any recommendations to business. These areas of regulation are "must haves" and Russia is expected to introduce a new "mandatory" block on compliance into the legislation, focused on combating corruption. This is driven in part by Russia's accession to the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions.

It must be noted that the approach to the management of the state and its economy is contractual that means the contract between people or enterprises has more importance than the law. The law is being observed by the people in such degree as it is observed by the Executive branch of the Government. One of the reasons for this situation is a current weakness of the law enforcement institutes. This contractual economy can be considered as my core reason for a high level of corruption, as the people and organizations do not believe that courts can issue a judicial decision based on facts. One of the first directions that should be taken in the fight with corruption is a complete change in the legal and judicial system. The courts should issue legally qualified judicial decisions; the people should have a confidence that the judicial decision is possible and such decisions will be timely and fairly taken. The judges should be aware that they are responsible for unfair, unreasonable and unqualified decisions. Definitely, during the past ten years many initiatives in frightening corruptions have been taken. Former President Dmitry Medvedev was very active in his period 2008-2012 in this direction. Of course, the key challenge is an effective implementation. Implementing anti-corruption strategy requires strong political will and an effective coordination between bodies and level of both governments.

Furthermore, researchers studying Russian corruption typically point to opaque legislation as one of the main reasons for the high level of graft in society. Among the

problems are the incompleteness and inconsistency of the laws, the high level of discretionary powers given to bureaucrats, and the possibility of conflict in judicial proceedings. But such an explanation is not complete. The presence of "correct" legislation does not guarantee its effective enforcement. The legislators gradually introduced additional changes into the law on forestry competitions and auctions with the goal of eliminating corrupt practices. But the anti-corruption laws do not always eliminate the corrupt practices; they simply change their form. Moreover, in its battle against corruption, the Russian Government is similar to the actions of the medieval inquisition, which held show trials against witches, burned "bad" books and wrote "good" ones. The Russian authorities also diligently rewrite laws and regularly use the media to inform the population about actions taken against bureaucrats who have gone too far. However, these actions do not change the situation because the people responsible for enforcing the new laws remain the same. It is possible that inserting civil society into the bilateral relationship between the state and business would improve the effectiveness and transparency of the deals that are carried out. Such a possibility deserves further investigation.

As a summary, Professor Michael Mainelli stated in 2009 "[…] historically, compliance has been an overhead or 'cost of doing business". Political responses to the Credit Crunch predictably call for more regulation – "never mind the quality, feel the width" – rather than better regulation, so while today's compliance costs are significant, tomorrow's costs are mounting. These costs have been increasing for two decades. Clear examples of this statement are the following compliance documents that needed to be implemented into the business processes: Corporate Governance: 1992 Cadbury Report, 1995 Greenbury Report, 1998 Hampel Report, 1999 Turnbull Report and 2003 Higgs report; German KonTraG corporate governance reforms; Sarbanes-Oxley Act 2002; and the OECD Principles of Corporate Governance, Basel, Markets in Financial Instruments Directive, Sarbanes–Oxley (Section 404), the Patriot Act, Anti-Money Laundering, the Financial Services Modernisation Act, the Financial Groups Directive, ISO 9000 as voluntarily incurred compliance, etc.

Internal and external drivers for compliance development in Russia

In the author's experience, one of the biggest internal influencers are the political actors that propose different ideas which later might become a piece of legislation or a change of the existing legislation. Another domestic factor is desire of various executives of the companies to improve the internal regulatory framework of their companies to comply with the ever-changing regulatory environment of the so-called inside compliance process. This drives a creation of internal compliance policies, codes of best practice, compliance regulations and manuals.

The local business practices of the big international companies, such as Kraft Foods, McDonalds, Coca-Cola, IBM, etc., shall be also treated as the one of the domestic influencers for compliance development in Russia. Some areas of the practices toward corruption, ethics, behavior and money laundering do the greatest effect on the Russian business practices as they are built into the local business environment. For example, global financial institutions, particularly American or those financial institutions with a US presence are required to maintain the highest degrees of AML/KYC compliance. This is due to the particularly stringent provisions of the USA PATRIOT Act and other US AML regulations applicable to such institutions. Consequently, such financial

institutions design their AML policies on the basis of these highest standards, which are then rolled out to their subsidiaries around the world to form the AML policies and processes of such subsidiaries. So, give or take a few duly approved deviations, as may be required by the local context, such institutions have identical check lists as they try to ensure they maintain their higher standards even where local context would accept more lax policies.

Conclusion

Corporate behavior has been subject to regulation since the early twentieth century, but in the wake of political and economic developments in the latter part of that century (deregulation, privatization, the collapse of communism and socialism), the spread of capitalism has also brought the by-product of corporate misdeeds and increasing regulation to rein in those misdeeds. The accounting scandals in the USA, such as Enron, WorldCom and Arthur Andersen, corporate governance shocks at Shell and Equitable Life in the UK, corporate fraud scandal with Parmalat in Italy, bankruptcy of Bear Stearns, Lehman Brothers, the UK bank Northern Rock, consumer fraud made by the famous Russian investment pyramid MMM, all of which have occurred in the past 10-15 years, have sharpened demands around the world for more regulatory oversight.

The myriad laws and regulations around money-laundering, anti-bribery laws, insider dealing and market abuse and other areas have prompted companies to develop internal resources that would actively monitor compliance with these laws and regulations. Moreover, in response to the increase in corporate scandals and the perceived inconsistency of criminal sentencing, the US Sentencing Commission created the first federal sentencing guidelines for organizations in November 1991.

The demand for compliance work seems to be flourishing now more than at any time in the past 100 years. However, it appears to be very little research on the dynamics of compliance in the above mentioned areas within the financial services sector. The focus here is on making sense of compliance issues around financial regulation within the Russian regulatory framework. The regulator may deploy a variety of strategies to effect compliance, just as the regulated is likely to deploy a variety of strategies to manage the regulator's expectations, attempts to hide issues from the regulator or negotiate terms with the regulator. Drawing on policy approaches to managing complex regulatory issues within such different contexts may offer novel insights to compliance issues within Russian financial services.

Notes

1. Instruction of the CBR N603-U dated July 7, 1999.
2. Federal Law N251-FZ-FZ dd 23.07.2013 "On the Introduction of Amendments to Certain Legislative Acts of the Russian Federation due to transfer the authorities for regulation, control and supervision within the financial markets to the CBR".
3. Since the official implementation of the AML/CFT law in Russia, there have been a lot of formal activities of the CRB and Rosfinmonitoring, including information letters, decrees of the Central Bank and Rosfinmonitoring, orders on particular issues, etc in amount of more than 5000 documents.
4. Since 2001, there have been more than 100 licenses for banking operations revoked on the territory of the Russian Federation.

5. Progress report MONEYVAL (2009) 30. Russia is a member of the Committee of experts on the evaluation of AML measures and the financing of terrorism (MONEYVAL). www.coe.int/moneyval
6. Federal Law No. 134-FZ "On the Introduction of Amendments to Certain Legislative Acts of the Russian Federation with a View to Countering Illegal Financial Operations" of June 28, 2013.
7. Federal Law N 224-FZ "On counteracting the Abuse of Inside Information and Market Manipulation and on the Amendment of Certain Legislation Acts of the Russian Federation" dated July 27, 2010.

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