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“What Lies Beneath” is a series of limited distribution reports prepared exclusively for Macro-Advisory clients that look at headline grabbing events, going deeper than the headlines.

The art of distraction

“Of two close friends, one is always the slave of the other.”

Mikhail Lermontov *“A Hero of our Time”*

- Western and Russian headlines have been grabbed by last week’s revelation that a businessman with connections to President Putin’s friends bought apartments for women linked to the president. This was followed at the weekend by the “Panama Papers”, showing that a friend of Putin’s had been linked to large money flows via offshore companies.
- The event that the Russian elite is watching, though, is the arrest order for a senior Russian official who, it is alleged, could show a link between close Putin associates and organized crime.
- That official is Nikolai Aulov, a deputy of Viktor Ivanov, head of the Federal Drugs Control Service, who also figured in the report on the death of Alexander Litvinenko.
- Putin had a public televised meeting with Ivanov the evening after the accusations against his deputy. This was a show of support, but it is also telling that Ivanov needs support.
- While nobody is suggesting that President Putin has any connections with crime groups, some of his trusted associates are alleged to have had links with dubious groups in the 1990s.
- It is worth placing this into the context of the wild 1990s and also in the context of Russian politics. In a representative democracy, politicians have their friends chosen for them by the electorate. In a managed democracy, politicians impose their friends on the electorate.
- The reason we highlight this event is to focus our clients on the real stories inside Russia, not just those in the media, and to explain the ensuing risks for foreign investors.
- But, the message for foreigners is that so long as they stay outside this system, i.e. stick to business and avoid politics, these events should not affect them whatsoever.
- The system treats outsiders differently from how it treats its own. Foreigners in Russia are treated well as long as they stick to the rules of the game, and tend to be crushed if they try to become part of the system.

Protesting too much

Chronicle of a smear foretold. Around 29 March, the president's press spokesman, Dmitry Peskov, made an unusual announcement. He warned of a building news story that was designed to discredit Russia and its leadership, and which was sponsored by "external enemies". He cited the leading questions that he had been asked, and which he chose not to dignify with a response. This is unusual because the Kremlin normally does not make this sort of comment. If a story is not worth dignifying with a response, then why draw attention to it?

Apartments for those close to Putin. The big story that broke on 31 March was that an associate of Putin's known friends, the Rotenberg brothers, had bought apartments for four women who have direct and indirect links to Putin. One of them is a woman reported to be Putin's daughter. Two of the women are related to Alina Kabaeva, a gymnast widely rumored to have been Putin's mistress. The fourth was photographed in a students' calendar in support of Putin. The associate, Grigorii Baevskii, had been a business partner of the Rotenbergs from 2011 to 2014, and during that time he had received orders from state bodies to the tune of about US\$100 mln.

The Panama Papers. A further leak over the weekend stated that an old friend of Putin's, a classical musician remote from business, turned out to be the owner of companies that processed complex multi-million dollar transactions. The appearance is that he was the custodian of these assets for a third party. There does not appear to be any definitive evidence that would connect the current Russian political elite to any of these transactions. As always, though, the name Putin creates headlines and presumably sells newspapers. But the fact is that dubious transactions via shell companies are nothing new, and should be no surprise.

Why draw attention to it? As a rule we avoid seeing a conspiracy in events that can be explained by straightforward competence. Here though, there is evidence of a polished press professional trying to draw attention to a story by vigorously denying it. Given that this is happening, it is a logical assumption that the idea is to draw attention away from another story.

A story worth burying. The other story that broke on 31 March was that a Spanish court has issued an arrest order for Nikolai Aulov, a deputy head of the Federal Drugs Control Service (Russian acronym FSKN). Aulov is accused of involvement in the work of a Russian crime gang which was operating on the south coast of Spain prior to 2008. The gang is accused of money laundering, gun running, drug smuggling, and illegal trade. The investigators have released sensational recordings of phone calls that involve Aulov, suggesting that other senior officials were also involved in the work of the organized crime group, including Putin, and some of his longest-serving associates from St Petersburg.

The Spanish Connection?

Organized crime in Malaga? Surely not? The British press have long referred to the Costa del Sol as the Costa del Crime, as it is the preferred hideout for British criminals evading Scotland Yard. Given the area's history of hospitality and its climate, it is not surprising that it was attractive to similar-minded Russians. The Spanish authorities started investigating Russian organized criminals in their jurisdiction in 2004, possibly because instead of just hiding from investigations, they were actually engaged in criminal activity in Spain, or at least coordinating it.

Phone taps. The smoking gun in all this is a series of phone conversations. One of the criminals under investigation is Gennady Petrov, who at one time in the 1990s was a shareholder in Bank Rossiya, which is owned by the Rotenbergs. (Incidentally, one of the transactions in the Panama Papers involves a small shareholding in this bank.) In a two-year period, there were 78 conversations between him and Aulov, who was at that time head of the Internal Affairs Ministry for the Central Federal District. The phone calls imply close relations between Petrov, Aulov and a number of senior government officials, including Viktor Zubkov, prime minister from 2007 to 2008, and now chairman of the Board of Gazprom, Anatoly Serdyukov, defense minister from 2007 to 2012, and Alexander Bastrykin, head of the Investigative Committee, as well as Viktor Ivanov, head of the FSKN.

Evidence of a coterie. The content of these calls implies that Aulov and the people around him were able and willing to take decisions that would benefit Petrov and his associates. In particular, Aulov takes credit for the arrest of the head of a rival criminal gang in St Petersburg, and for disciplining police officers who were investigating Petrov's criminal activities. Aulov said that "the Tsar" had given the order for the arrest of the St Petersburg criminal boss Vladimir Barsukov, head of the Tambov mafia.

Was it really Aulov? On 31 March the FSKN responded to the warrant for Aulov's arrest by saying that there was no voice print evidence that it was Aulov, calling the investigation "unprofessional". There is circumstantial evidence pointing to it being Aulov on the phone because of references to him in other conversations receiving a promotion. Ivanov, Aulov's boss, has publicly admitted that Aulov did call Petrov because he was using him as an informer. Presumably if there is solid evidence that it is not Aulov on those phone calls, it will be produced.

Ivanov and Litvinenko. Viktor Ivanov was an important figure in the report into the death of Alexander Litvinenko in London in 2006. Litvinenko was working for a security company in London conducting due diligence reports on Russian individuals and businesses. He hired Andrei Lugovoi (who was accused of poisoning Litvinenko) to write a report on Viktor Ivanov. That report was deemed inadequate, and Litvinenko hired someone else to do it. This improved report was sent to Lugovoi, presumably as an example of what would be required in the future, and was promptly shown to Ivanov. It is alleged that this may have contributed to the trail of events that led to Litvinenko's death. Ivanov has strenuously denied any involvement, although he did admit the link between Aulov and Petrov that had been revealed by Litvinenko.

What is the picture that emerges? There is evidence that a senior law enforcement official was working with a man who is under investigation by Spanish authorities. But that does not appear to be damning evidence that any senior Kremlin officials are part of an organized crime group. Yes, they may have had contact with them, in the past, but this was part and parcel of local politics in Russia in the 1990s. Just because something was expedient back then does not mean that it is accepted practice today. Probably the worst that can be alleged is that Putin chose not to fire senior law enforcement officials who provided help for criminal gangs to fight one another. This is similar to his tactics in Chechnya, where he backed one local warlord against another, a tactic that has been successful in reducing fighting in the region. Choosing the lesser of two evils is something that we expect of politicians.

Alternative explanation for the Petrov-Aulov contacts. It is also possible that some of these contacts are still useful for government work. It is accepted Russian practice to tolerate a certain amount of illegal activity in return for general stability in a region. A Russian official in charge of policing narcotics might well do a deal with a crime boss to turn a blind eye in order to keep tabs on a particular region. There are also allegations that some elements within the Russian government used criminals to help them sell weapons to groups that they wanted to support, including Syria. The Russian government would see this as legitimate Black Ops, given that the US government has admitted arming the Syrian opposition. As for Putin's involvement, this could well be just bragging – it is not unheard of for subordinates to produce second-hand gossip as evidence of their access to inner circles.

Spanish prosecutor is also just doing his job. There is no reason to assume any political subtext in the work of the Spanish prosecutor, who seems to be just doing his job in terms of dealing with criminal activity within his jurisdiction. The prosecutor has been active in trying to lobby the US government and Russian public opinion to bring what he sees as criminals to justice.

Clans within *sistema*. The picture that emerges from the Aulov-Petrov tapes is that of a group of people with long-standing relationships helping each other in business and politics. The president rules Russia via a group of trusted people, who are grouped into clans. This system has been described by Professor Alena Ledeneva as *sistema* (her book, ***Can Russia Modernize: Sistema, Power Networks and Informal Governance***, was published in 2013), which is how it is known in Russia – a particular network of relationships and favors that holds together loose bands of powerful individuals.

Putin sits on top of *sistema*. The president's importance to Russian politics is that he is essentially chosen by the main players as an arbiter, because he has loyalties and connections to all of them. Hence each of them is willing to accept his judgment. Often this judgment is announced via a public meeting with the winner of a particular dispute. It was noticeable that Putin had a public meeting with Viktor Ivanov, shortly after the announcement of the warrant for Aulov's arrest. This would have been understood by *sistema* players as a vote of confidence in Ivanov. Other clans, especially the *siloviki*, which control the Internal Affairs Ministry, have been trying to abolish Ivanov's FSKN for some time.

The Zubkov clan. Ivanov's clan is centered on Viktor Zubkov, whose son-in-law was Anatoly Serdyukov and who has worked with Viktor Ivanov. It was suggested at the time that Serdyukov's divorce from Zubkov's daughter led to his fall from grace at the Defense Ministry. At the same time, Serdyukov did push through reforms at the ministry, making the army less conscript-based, and with better internal financial controls. The point here is that just because someone is a member of a clan does not mean that they are not competent.

***Sistema* is only for insiders.** One of the biggest mistakes that a foreigner can make in Russia is to believe that they can fully understand or become part of *sistema*. It is not even clear that all the Russians involved fully understand it. The fact is that the actions of *sistema* are unpredictable and can backfire on outsiders. So it is important to beware of those who claim to give you access to players in this game with a view to changing the rules.

What should foreign investors do? Rule number one is to avoid short cuts and do things strictly by the book. In most spheres the rules of the game and laws are transparent, and the authorities will respect your attempts to adhere to them. For those sectors which have a heavy *sistema* presence such as natural resource extraction or government construction contracts then this rule becomes doubly important. It can make sense to partner with a local player after doing thorough due diligence. Alternatively, if it seems clear which side to take, then participation should be on an arms' length basis, focusing on a clear contracted role without claiming equity participation. Local players may be able to use *sistema* to compete unfairly with foreigners, but they are as likely to fall foul of the system as a foreigner, unless they are insiders themselves. There are plenty of precedents where foreigners have lost contracts to well-connected locals, only to be rapidly re-invited to tender when it became clear the locals could not deliver the services promised.

How should we think about the Panama Papers? No one doubts that senior Russian politicians have become wealthy over the past fifteen years, and that they have found ways to park their assets with trusted associates. Note that the sums involved fall well short of the US\$40 bln that Putin was alleged to have stolen earlier this year. In a way, it is encouraging that senior Russian officials feel the need to conceal their wealth. It would be worse if they felt such impunity that they could flaunt their wealth at the people they rule. There are rules of the game in Russia, and although they are far from ideal, the general tendency over time in most countries has been to migrate towards a more transparent and less criminal system, and Russia can be expected to take the same course.

Conclusion. Russian political discourse is complicated, and needs to be interpreted on its own terms, rather than analyzed for its conformity with Western norms. It is a reasonable assumption to make that, in the 1990s, some people in government had links with organized crime, and it is possible that some of these links may have been maintained. One reason for maintaining these links is so the state can use such groups to do what the state cannot do itself. The Russians see these as “acceptable tricks” that are allowed within the ruling system of statecraft and would point to roughly similar acts by either the US or Israel or other nations as justification.

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