

Strengthening the Rule of Law for U.S. Business in Russia
Testimony of Alan Larson
before the Senate Finance Committee
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Chairman Baucus, Ranking Member Hatch, and other distinguished Senators—thank you for the invitation to testify at this hearing. My name is Alan Larson. I am a Senior International Policy Advisor at Covington & Burling LLP, the Chairman of the Board of Directors of Transparency International-USA (TI-USA), and a former Under Secretary of State for Economic Affairs during the administrations of Bill Clinton and George W. Bush. My testimony has been informed by experiences in each of these roles, but my testimony today reflects my personal views and it does not necessarily represent the views of any of the organizations with which I am or have been affiliated.

Russia is a proud country, a permanent member of the United Nations Security Council, a military superpower and a member of essential economic policy forums such as the Group of Twenty (G-20) and the Group of Eight (G-8). The United States should seek to have relations with Russia that are grounded in mutual trust and mutual respect.

I believe that the United States stands to benefit greatly as Russia becomes a full participant in those rule of law disciplines that provide a foundation for international business relations. I believe that three sets of such rule of law disciplines—one can think of them as three sides of a triangle—form the foundation for a solid rule of law framework for international business relations: (1) trade disciplines, including especially WTO disciplines; (2) investment disciplines, including those found in bilateral investment treaties; and (3) institutional integrity disciplines, which ensure that the rule of law is applied in an evenhanded manner, including arrangements that control corruption. These three sets of disciplines form an interlocking triangle. When only one or two sides of the triangle are in place, the rule of law framework is not as strong or as stable as it is when all three sets of disciplines are in place. I urge Congress and the Administration to work together with the Russian government to make simultaneous progress in all three areas, even as Congress moves swiftly to extend Permanent Normal Trade Relations (PNTR) to Russia.

It is a very good thing that Russia has completed the process of accession to the World Trade Organization. Russia's accession to the WTO serves the trade and foreign policy interests of the United States in many important ways. WTO accession means that the rule of law will apply to most important parts of the trade relationship between Russia and the United States, putting into place one side of the rule of law triangle. Russia's commitment to rule of law disciplines with respect to trade represents a very important step forward for U.S. business.

Congress should extend PNTR status to Russia right away. Russian businesses and workers should obtain the access to the market of the United States that the Government of Russia bargained for in its negotiations to accede to the WTO. The trust on which good relations between Russia and the United States are premised will be reinforced when the United States extends PNTR to Russia. Moreover, the extension of PNTR is necessary to allow U.S. firms to

gain the benefits that flow from Russia's accession to the WTO. If Congress were to delay the extension of PNTR to Russia, U.S. firms would find themselves at a competitive disadvantage in the Russian market in comparison to firms from third countries.

WTO disciplines usually are subject to state-to-state dispute settlement. This means that if either Russia or the United States were to take actions that may violate its WTO commitments, the other party can challenge the disputed practice before a WTO dispute settlement panel. This ability to bring challenges before a neutral third party provides a powerful reinforcement of the rule of law to trade practices, protecting traders against arbitrary and mistaken national application of internationally agreed trade rules. Access to third party dispute settlement is an essential part of the international system of checks and balances that helps ensure the fair application of the rule of law within jurisdictions such as Russia.

Resort to dispute settlement procedures by no means indicates that the parties to a dispute do not enjoy friendly relations. The United States enjoys excellent relations with the European Union and is a treaty ally of many of the European Union's member states. Nevertheless, the United States and the European Union regularly bring WTO dispute settlement cases against each other. In fact, the ability to put contentious trade disputes into a technical forum for resolution actually enhances the friendly relations between us by limiting the extent to which trade disputes become political disputes.

Prompt extension of PNTR to Russia is a necessary condition for the rule of law to be extended to the business relationship between Russian and the United States, but it is not a sufficient condition. The rule of law, including the well-established strictures of customary international law, should apply to investments in the United States made by Russians and Russian companies and to investments in Russia made by Americans and American companies. Investment disciplines can be thought of as the second side of the triangle that is necessary for a solid rule of law framework for international business.

The most important investment disciplines are included in bilateral investment treaties or "BITs." BITs generally provide guarantees of non-discriminatory treatment, protection against unlawful expropriations, and opportunities for investors to resort, if necessary, to investor-state dispute settlement with independent arbitration panels. At present, the United States and Russia do not have a BIT governing investment relations. The two countries signed a BIT in 1992, and the United States Senate ratified the agreement in 1993, but the Russian Duma never followed suit, reportedly due in part to Russian legislators' fear that the BIT would give Western energy companies too much leverage over Russian natural resources and in part to domestic political conflict between the parliamentary majority and then-President Yeltsin.

The absence of BIT protections has been a serious shortcoming, especially for U.S. investors in the energy sector. To take one example in which I have been involved as a policy advisor, the Government of Russia took actions between 2004 and 2007 that dismantled Yukos Oil Company, a privately-owned Russian oil company whose shares were available to foreign investors. U.S. investors, both investment funds and about 20,000 individual investors, collectively owned about 15 percent of Yukos. Experts on Russia's domestic politics have speculated that then-President Putin wanted to re-establish the control of the Russian government

over Russia's oil sector and may have been concerned about the potential political competition that Yukos CEO Mikhail Khordokovsky could present. Whatever its motivation may have been, Russian government's actions amounted to an expropriation of the investments of U.S. and other foreign investors in Yukos in a manner contrary to customary international law. The total loss to the U.S. investors was about \$12 billion. Because Russia never ratified the Russia-U.S. BIT, U.S. investors do not have the same opportunity to pursue investor-state arbitration as do investors from many other jurisdictions. In commenting on this case, a State Department press spokesman said at the time, "Many of the actions in the case against Khodorkovsky and Yukos have raised serious concerns about the independence of courts, sanctity of contracts and property rights, and the lack of a predictable tax regime. The conduct of Russian authorities in the Khodorkovsky Yukos affair has eroded Russia's reputation and confidence in Russian legal and judicial institutions."

My colleagues at Covington & Burling LLP and I represent certain U.S. investors in Yukos who have petitioned the State Department to "espouse" their claims. Through espousal, the United States government would take on the claims of all U.S. investors in Yukos and would seek to work out a collective settlement with Russia, either through negotiation or the establishment of an *ad hoc* arbitration process established by Russia and the United States for this purpose. In reflecting on the predicament faced by U.S. investors in Yukos, I have seen in a new light the vulnerability of such investors in the absence of the dispute settlement provisions provided by a bilateral investment treaty. I obviously and admittedly represent an interested party in this particular matter, but my experience in working on it has persuaded me that the United States should immediately espouse the claims of the U.S. investors in Yukos, even as the United States moves immediately to extend PNTR to Russia. Russia and the United States each need to demonstrate that they are committed to the rule of law, especially as it pertains to U.S. investments and U.S. investors.

In addition, the United States should seek immediately to initiate negotiations with Russia on a new, more up-to-date bilateral investment treaty. Such a treaty, once ratified by both countries, would provide protection for Russian investors in the United States as well as for U.S. investors in Russia. In doing these things, Russia and the United States would be putting into place a second side to the rule of law triangle for business relations between our two countries.

On February 9, 2011, Prime Minister Putin published in the *Washington Post* an essay on the importance of stamping out official corruption. He wrote that "[t]o combat systemic corruption we need to unbundle power and property and to separate executive power from the system of checks over it. The political responsibility for the fight against corruption must be shared by the government and the opposition." He also called for increased salaries for government officials and managers of state-owned companies in exchange for "absolute transparency" regarding their personal finances and proposed an expansion of the court system to hear more complaints against corrupt officials.

It is heartening that the Prime Minister, who has claimed victory in Russia's March 4 elections to select Russia's next President, acknowledges the importance of ensuring institutional integrity, the third side of the rule of law triangle for international business. Institutions imbued with integrity are essential for the functioning of the rule of law. Without such institutions, the rule of

law can be distorted into a corrupt and authoritarian parody that former Secretary of State Albright once called not rule-of-law but “rule by law.”

In 2009, TI-USA and I were part of a private sector study group composed of Russian and American NGOs and business associations. We prepared a joint report called *Russia-US Joint Working Group on Investment and Institutional Integrity* and submitted this report to President Medvedev and President Obama. On the margins of the July 2009 Medvedev-Obama Summit meeting, President Obama listened while my counterpart, the Chair of the Russian chapter of Transparency International, Elena Panifilova, presented our summary conclusions.

Some of these conclusions already have been adopted. Notably, Russia has passed a law making it a prosecutable offense for Russian business executives to bribe foreign government officials in order to secure business. In addition, Russia has acceded to the Anti-Bribery Convention of the Organization for Economic Cooperation and Development. These are important and very welcome steps.

Accession to the OECD Convention does not mean, of course, that Russia’s new law will be instantly and comprehensively enforced. It took several years for many Western European firms to begin carrying out their obligations under the OECD Convention; some signatories to the Convention still are not carrying out their responsibilities as fully as we in TI-USA think they should. In fact, TI-USA has joined several business organizations and the AFL-CIO in urging the Administration to take vigorous action to level the international commercial playing field by ensuring that all signatories to the OECD Convention fully implement their obligations under the Convention. We believe the Administration should apply the same standard to Russia.

Even full Russian implementation of its obligations under the OECD Convention will not directly address the problem of corruption within Russia, which is widely seen as infecting Russia’s administration of tax and customs policy and its judiciary. Former Secretary of State Condoleezza Rice stated in a *Washington Post* Op-Ed on March 8, 2012 that, “When Putin took office, he reestablished the arbitrary power of the state—destroying the independence of the judiciary; appointing governors rather than electing them; and all but closing down independent television.”

Russia and the United States apparently are working together, through the Bilateral Presidential Commission Working Group on Rule of Law, under the leadership of the U.S. Department of Justice and the Russian Ministry of Justice to address issues of the rule of law and controlling corruption. This work deserves to be given the highest priority.

I also believe it continues to be important that representatives of civil society organizations be afforded opportunities to contribute to such work, as TI-Russia and TI-USA did in the *Russia-US Joint Working Group on Investment and Institutional Integrity*. Civic organizations provide an essential role as watch dogs, helping to ensure institutional integrity. It is important that civic organizations be permitted to monitor, investigate and report on suspected instances of corruption.

By vigorously pursuing full implementation of the OECD Convention, by engaging an active bilateral Russia-U.S. agenda on the rule of law and by expanding the scope for civil society organizations to play a watch dog role, Russia and the United States can assure increasing levels of institutional integrity, laying down the third side of the rule of law triangle for stable business relations.

Mr. Chairman, let me summarize my recommendations:

1. I recommend that Congress immediately extend Permanent Normal Trade Relations to Russia.
2. I recommend that the Administration and Russia, with the support of Congress, immediately initiate and vigorously pursue negotiations for a bilateral investment treaty.
3. I recommend that the Administration, with the support of Congress, advocate for U.S. investors in Russia and immediately and vigorously espouse the claims of the U.S. investors in Yukos, whose investments in Russia were expropriated.
4. I recommend that the Administration, with the support of Congress, immediately and vigorously work to ensure that all parties to the OECD Anti-Bribery Convention, including Russia, fully carry out their commitments under the Convention.
5. I recommend that Russia and the United States, with the support of Congress, immediately and vigorously intensify their cooperative work to ensure that their respective government operations and judiciaries are governed by integrity and the rule of law, and are resistant to corruption.
6. I recommend that Russia and the United States, with the support of Congress, cooperate in immediately and vigorously expanding the scope for civil society to play an independent watch dog role on rule-of-law issues, especially corruption.

By taking all these actions with vigor and determination, the United States and Russia can ensure that Russia's WTO accession and the establishment of Permanent Normal Trade Relations between our two countries will mark the beginning of a new era, one that is marked by the full application of the rule of law to our bilateral business relations.