

Moving Money, Making Money, and Parking Money Overseas: Front Companies in Offshore Jurisdictions

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The major challenge facing Russia and Ukraine today is the adoption and acceptance of internationally recognized business practices. Recent scandals, such as the Russian Bank of New York and the Ukrainian Pavlo Lazarenko cases, show that Russian and Ukrainian elites have sometimes engaged in unethical and criminal activities. The problem is not only in the ethical norms but in the very nature of economic relations in the countries. Russia and Ukraine, as well as many other countries in the region, will either opt for market driven prices, competition, and regulated markets, or they will face continued poverty, economic decline, and political instability.

Private enterprise in post-Soviet societies emerged from nomenklatura socialism, a system of privileges and the exercise of autocratic power from the top down. Prearranged privatization, under-the-counter sales, double accounting, and monopoly of production by a few powerful tycoons have created a capitalism that is deeply flawed. Some scholars argue that it is not capitalism at all but something new, a virtual economy, a hybrid between Soviet capitalism and feudalism.¹

The centralization of the Soviet era has gone, but what has replaced it is patronage dispensation by a few magnates—the so-called oligarchs. The elements of healthy entrepreneurship that had been the backbone of Russian and Ukrainian capitalism in the nineteenth century—free competition, hard work, savings, and investment—are barely present today. Instead, Soviet era monopolies turned themselves into private corporations, largely by nontransparent government fiat, without any competition or supervision, and they have accumulated enormous wealth that is hidden mostly overseas in private bank accounts. The 1990s will no doubt be remembered as a decade of pillage, capital flight, and criminalization of the economy, a great redistribution of property comparable only to the nationalization carried out by the Bolsheviks.

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Deeply uncertain about their grip on power, the post-Soviet elites have tried to relocate assets where they would be safe—in offshore bank accounts, in real estate in Western countries, and increasingly in investment in legitimate business in the West. This raises a number of questions, regarding, for example, the role of offshore banks and other offshore companies in Russian/Ukrainian asset stripping, as well as the matters of capital flight and money laundering.

There are essentially three stages in the process that need to be reconstructed:

- How assets were generated in quantities that allowed for large-scale transfers abroad
- The mechanisms that were used to shift earnings overseas
- The extent to which the shifted assets had criminal origins

Moving Money: Offshore Businesses

Export-import operations, offshore intermediaries, and international wire banking are the main channels for Russian and Ukrainian funds flowing abroad. The mechanism for shifting assets overseas is simple: Russian producers of an exportable commodity surround themselves with intermediary companies, including those offshore. They buy aluminum or oil from their own subsidiary at a low domestic price and sell it, also at a low domestic price, to offshore companies. By doing this, they pay low taxes on a low-priced commodity. Then the offshore company they own or control sells the commodity at the world market price, and the enormous profit stays in the West.

Major Russian exporters of oil and gas, timber, and metals set up a complex web of intermediaries with the sole purpose of siphoning off revenue to offshore zones and Western banks. For example, Sibneft, a major Russian oil company, exports oil to its offshore affiliate, Runicom, at a low price. Runicom then sells the oil to Western consumers at the world price. As one analyst in Russia wrote: “This is an absolutely standard procedure. . . . Practically all Russian exporters of oil do this. ‘Slavneft’ exports oil through ‘Slav-neft-Belgium,’ Ukos through ‘Rautenhold,’ and Sidanko through ‘United Petroleum’”²

A complex system of bank transfers is designed to obscure the origin of the funds generated by untaxed skimming of Russian national resources. Some of the funds are used to purchase Western real estate and luxury items. Most is deposited in personal bank accounts in Western financial institutions, and some of it comes back to Russia or Ukraine in the form of a “foreign” investment.

The number of Russian and Ukrainian offshore companies grew steadily during the 1990s. At present, there are 60,000 Russian and/or Ukrainian offshore companies.³ In Europe, the favorite places of registration are the Channel Islands and Cyprus; in the Americas, the Caribbean; in the Pacific, the Cook Islands.

Russian offshore companies should be seen as a mechanism of shifting Russia’s wealth overseas beyond the reach of the Russian government. They are a new factor in international commerce and finance in which enormous financial resources have been accumulated. That would not have been possible without major involvement of Western commercial and banking institutions. Western law

firms, brokerage firms, governments of offshore zones, and banks have been exploiting for their own benefit the steady flow of capital out of Russia, some of it with unclear origin.

Moving Offshore—Cyprus

Cyprus has become a darling for Russian and Ukrainian companies.⁴ What has lured most Russian companies to Cyprus is a so-called dual treaty between Russia and Cyprus, which accords Russians many tax advantages. For example, normally Russian companies would pay 35 percent tax on profits, plus a 20 percent VAT tax, and a 40 percent tax for social security and employee benefits. If, however, a Russian business is structured so that a Cyprus company owns it, without any physical presence in Russia, it can legally transfer profits to Cyprus and is liable for only a 4.5 percent tax on profits and a 15 percent VAT tax. It escapes the 40 percent tax for social services. This tax advantage makes it possible to channel profits in the form of dividends at a reduced rate.

Another advantageous method is the payment of interest on loans. Under the law, a Cypriot company receives payments for its loans to Russian companies, avoiding almost all taxes. However, the interest payments are never actually paid to the Cyprus company. So if a Russian company wants to minimize its tax payments and shift its revenue abroad, the most effective method is for the company to be partly owned by a Cypriot company and pay interest on loans to the Cypriot company.

Ingenious Russian tax evaders have developed more ways of escaping the tax police. In Russia, there are domestic “economic” zones with reduced taxation, such as Kaliningrad and Ingushetiya and Kalmykia. Companies registered in those jurisdictions pay lower taxes than those paid in other Russian jurisdictions.⁵ If tax evaders structure their business in such a way that they service a Cypriot company’s business in Russia, they pay even lower taxes. They can transfer revenue earned in Russia abroad in the form of dividends and interest at considerable tax savings.

The methods described above are perfectly legal if structured properly, and they make it possible for hundreds of millions of dollars to flow out of Russia. Some other methods of capital transfer are legally questionable, such as the so-called Latvian-bound bank transfers.

Latvian Bank Transfers

Under Russian tax law, any hard currency transfer abroad must receive the approval of the Central Bank. To circumvent this requirement, which would trigger a tax payment, many Russian businesses wire money in rubles to Latvian banks as payment for various fictional services or contracts. Latvian banks have positioned themselves for the needs of Russian and Ukrainian businesses that rely on domestic currency wire transfers. Russian or Ukrainian wire transfers in domestic currency do not violate any law because the transfers are made in rubles or hryvnas. The next step in this operation usually involves a telex or fax to a Latvian bank with instructions to forward the payment to a third party elsewhere in

hard currency payment. This instruction is not a violation of any Latvian law. However, taken together, the first and the second steps amount to a hard currency transfer without Central Bank permission and constitute tax evasion. In many cases these payments are camouflaged as payments on contracts for commercial ventures. In reality, the contracts are often nothing but a cover. Those engaged in such operations can be charged with illegal hard currency operations, tax evasion, and fictitious entrepreneurship.

Interest and dividend payments to Cyprus and ruble wire transfers via Latvia are the most cost-effective ways to get money out of Russia. An important regulation, however, sets Cyprus apart from other offshore jurisdictions. The Central Bank of Cyprus requires disclosure of the ultimate beneficiary and/or owner. Companies that need to avoid disclosure of the beneficiary owner put their businesses in the Caribbean or Pacific islands where secrecy prevails, rather than Cyprus.

Making Money—Asset Stripping

Enterprise stripping is a uniquely post-Soviet phenomenon that exists in what one observer called the virtual economy.⁶ In a traditional context, enterprise stripping is associated with a company taking over a competitor and destroying it as an unnecessary rival. What is unusual about post-Soviet enterprise stripping is that it has been done primarily by the enterprise owners or managers themselves. Rather than serving the long-term prosperity of the enterprise or its shareholders, many have acted as Soviet managers but are now accountable to no one. They aspire to grab as much as possible today and run, even if that means the destruction of the enterprise tomorrow.

A company buys a minority share of an enterprise, obtains an official license to manage the state's share of the stock, and then strips the enterprise of all valuable assets. They sell the assets of the enterprise, depriving it of working capital. Often salaries go unpaid, and employee labor is part of the theft.

This pattern of enterprise stripping started ten years ago under Mikhail Gorbachev during the so-called cooperative stage of privatization.⁷ As cooperatives were the only form of private enterprise allowed in Gorbachev's Soviet Union, enterprise directors set up cooperatives for the sole purpose of siphoning off resources from "their" state enterprises to the cooperatives that they controlled. State enterprises were stripped for the benefit of private co-ops. However, when private property was legalized, there was no longer a need for the co-ops. New front companies were set up to strip state enterprises of their assets and transfer them to the private companies. As a result, the state was left with the most capital-intensive parts of industry or infrastructure that required sustained maintenance expenses, and private enterprise acquired those generating the most revenue.

Example 1: A Russian Smelter, an Offshore "British" Trader, and a "Cypriot" Money Trust

This case concerns the Novokuznetsk aluminum plant, NKaP, one of the largest in Russia. Like other aluminum giants, it was privatized in 1994 in a prearranged auction. A consortium of Western investors led by Soingo, a Swiss company deal-

ing in aluminum with assets in Argentina and Hungary, was disqualified at the auction on the pretext that a little-known Moscow-based company, Mikom, offered a better deal. Mikom promised to invest \$18 million in the plant—a promise that was never fulfilled. In early 1995, the brothers Zhivilo took control of the plant by obtaining the majority of its stock. At that time, no one seemed to know who stood behind them. Later it became apparent that Mikom was linked with Trans World Group (TWG), one of the largest aluminum companies in the Russian market. Officially, it was known as a British company; in reality, it is Russian-controlled through its chief executive officer Lev Chornoy, a former Soviet citizen with an Israeli passport, a notorious figure closely watched by international law enforcement agencies.

“The details of what is known in Russia as the aluminum wars are still murky and law enforcement is ostensibly still investigating several contract killings.”

In the nonferrous metals field, as well as the aluminum industry, the Trans World group played a key role as a company with major investments in Russia, Ukraine, and Kazakhstan. It operated in all three countries through a system of subsidiary companies. TWG made enormous profits through tolling arrangements

with the Russian government, which essentially amounted to tax free importation of raw materials and tax free export of aluminum. This arrangement was convenient for both sides. The Russian state did not have the capacity to sustain its aluminum industry or any other industry.⁸ Western companies, including TWG, aspired to enter the Russian market on favorable terms. Tax relief on import of raw materials for a product to be exported was exactly what they wanted. TWG made enough capital to buy influence and the controlling shares in the aluminum industry.⁹ In the early 1990s, the chairman of the Metallurgical Committee and later deputy prime minister, Oleg Soskovets, personally brought Lev Chernoy to Krasnoyarsk and to other aluminum giants and suggested to their directors that they work with Chernoy.¹⁰ The cash-strapped plants had no choice but to sign up for tolling arrangements in 1992–93 because that was their only source of revenue.

The Great Aluminum War

With the initial capital derived from tolling, brothers Mikhail and Lev Chernoy and brothers Zhivilo at the Krasnoyarsk and Novokuznetsk aluminum plants (NKaP), respectively, moved to obtain controlling shares of stock at these plants. The old directors resisted vigorously. At one point in Krasnoyarsk, the claimants deployed security forces, hired a mob to “guard” the plant, and contracted killings. Using high-ranking patronage, prearranged auctions, and raw force, they gained physical possession of the plants.

The details of what is known in Russia as the aluminum wars are still murky, and law enforcement is ostensibly still investigating several contract killings.

The facts, however, are that in 1994 fierce struggle broke out for control of the Krasnoyarsk plant. Contending parties bought up available stock and exercised pressure to place their own people in management positions. Anatoly Bykov, a sportsman nicknamed Toliya Byk, was known as an “authority” in the Krasnoyarsk region, allegedly having extensive organized crime links. He was at one point vice president of Rossiiskii Kredit and served on the province дума committee on entrepreneurship. In 1999, he was charged with contract killings and money laundering.

In Bratsk, power struggles involved a well-known criminal “authority,” Tiurik. He was the link between the Achinsk aluminum plant and Chernoy’s empire of companies. During moves and countermoves by various claimants for control, several high ranking businessmen and officials wound up dead. Among them were the former deputy director of Krasnoyarsk aluminum, Vadim Yafyazov, and Yugorsky bank president Oleg Kantor. In November 1994, Yuri Karetnikov, deputy chairman of the Russian Federation Metallurgy Committee, was killed in a car crash.¹¹ The press labeled a spate of killings and mysterious deaths “aluminum wars.”

In early 1995, when they had taken control of the board of directors, brothers Zhivilo at NkaP abrogated a supply contract with Soinco and shifted their deliveries to the Trans World Group. This led to a protracted battle in the courts in Geneva and London, which the Zhivilo brothers lost, with Soinco awarded more than \$20 million. Because this arbitration was handled in Western courts, the evidence presented is a matter of public record. Asset stripping, capital flight, tax evasion, fraudulent transfers, double accounting, and other illicit activities by the new owners were documented during the proceeding.¹²

Part of the scheme was accomplished through Base Metals Ltd., registered in Britain, which supposedly imported NkaP aluminum from Russia and resold it to Western consumers. On the surface, it appeared to be a normal middleman distribution company. The arbitration proceedings revealed, however, that Base Metals Ltd. had no assets and no employees and that the only thing that it did was charge an exorbitant fee for a “paperwork” transaction. Base Metals Ltd. could not perform the task that it claimed it performed and was clearly controlled by the Zhivilo brothers. Its services did not justify a 30 percent mark-up of the price. On closer examination, the transaction was only a convenient way to siphon off revenue to the West by disguising it as a payment for services that were not rendered.

Brothers Zhivilo at first denied that they had any connection to Base Metals Ltd. But the court found that they were exporting the product to themselves and charging a fee for the transaction, at the expense of the plant that they controlled. Their purpose, as is so often the case in contemporary Russia, was not to invest in the enterprise they owned but to squeeze as much revenue out of it as possible at the cost of renovation and modernization. Once the lawyers established the ownership of Base Metals Ltd., its bank accounts in Britain were frozen and later were seized to enforce the Soinco judgment. The affidavit by the plaintiffs in the case summarized their view on the nature of the operation:

What quite clearly appears to have been going on, in short, as a direct consequence of the assumption of control of NkaP by the Zhivilo group, is that the proceeds from the sale of the valuable Russian industrial product, namely aluminum from NkaP, are only partially and minimally remitted to NkaP as primary producer, with the balance being diverted in the form of sizable profit margin and hidden away in various offshore letter box companies.¹³

The accounts of Base Metals Ltd. were serviced by Narodny Bank of London. During the Soviet era, Narodny Bank was the only Soviet bank that had offices in London. It was well known to have close ties to the KGB. Base Metals Ltd. was also represented by a trust company registered in Cyprus, which was in turn owned by Menatep Bank. Menatep Bank had roots in the Communist Party as a way to hide party money channeled to private business through patronage networks. At the very least, the banking mechanism was not one of transparency and reputation that one would respect.

Through this elaborate system of front companies, services, and fees, tens of millions of dollars were skimmed off the Novokuznetsk plant exports annually, \$95 million during 1996 alone. This calculation is based on the following facts: According to the British records, \$195 million dollars worth of aluminum was exported and sold at Western markets from Novokuznetsk. Of the proceeds, approximately \$100 million flowed back to Russia in the form of various payments, and \$95 million remained in the West. However, by Russian official records for 1996, the plant showed no profit at all. Thus, \$95 million was skimmed from one plant in one year. The documents of the case show that a number of shell companies were involved, not only Base Metals Ltd. A network of front companies operated at every stage of the process of transportation, processing, resale, and delivery of aluminum. Their sole purpose was to charge fees for ostensible services, provide cover to the real owners, and hide the profits from financial authorities and law enforcement agencies.

Example 2: Stolen Assets Shifted Overseas

Sovkomflot is the most glaring case of enterprise stripping. In 1990, Sovkomflot was a large Soviet company in the commercial shipping business. In 1995, it was legally converted into a state-owned company whose shares were entirely owned by the Russian state.¹⁴ In theory, the company was to generate revenue for the Russian treasury. Under Russian tax law, the company would have to pay corporate taxes and taxes on profits generated on the Western market.

What happened in reality illustrates the Soviet nature of contemporary Russian capitalism freed from restraint. A report by the Russian Chamber of Accounts documents the fraud that really occurred. In essence, the managers of Sovkomflot acted as if they were the owners of the state company, and they disposed of its assets and revenue. They used a double-tier accounting system, one for their state-official superiors and another for themselves. The majority of their shipping services were never recorded in the official accounting reports. In other words, they engaged in *nalevo* (shipping under-the-counter) services. In addition, the managers transferred some of the company's ships to foreign registration. As the report of the Chamber of Accounts states,

Transfer of ships to the registration of other countries and sailing under their flags led to the reality that considerable financial flows began to pass through the accounts in foreign banks.¹⁵

By the mid 1990s, more than half of former Soviet commercial vessels sailed under the Liberian flag. In addition to fraud, tax evasion, asset stripping, and wholesale transfer of ships to foreign flags, the managers appropriated revenue into their personal accounts by a complex system of payments through front companies. Maintenance needs and insurance coverage of plants were ignored, as the owners strove to hide as much unrecorded and unaccounted revenue as possible in foreign accounts. The Sovkomflot case illustrates the de facto privatization of a state company without any auction or sale. In theory, the company remained in the possession of the state; in practice, unscrupulous and corrupt managers stole and ruined it.

A report on the airline industry in Russia by the Chamber of Accounts shows a vivid picture of enterprise stripping. Airports, restaurants, and profitable airlines were privatized. The state was left with expenses to maintain runways and basic infrastructure, which degenerated recently to a catastrophic level because of lack of capital investment and poor maintenance.¹⁶

The disappearance of the Russian commercial fleet into foreign ports and under foreign flags could not have happened merely through the criminal acts of Sovkomflot managers. High-ranking patrons in Moscow had to provide *krysha*, protection to the criminals for a fee. Indeed, this is a case that manifests most of the elements of economic crimes: fraud, embezzlement, tax evasion, enterprise stripping, shifting of operations overseas, and protection of and collusion with highly placed officials.¹⁷

During this time, other state shipping and fishing companies opened bank accounts in Norway and South Korea and moved operations overseas where they were inaccessible to the tax police.

Another shipping firm, known as the Vladivostok Base of Trawling and Refrigeration Fleet (VBTRF), was bankrupted by asset stripping. VBTRF, once the employer of 10,000 workers with revenues of \$200 million, was reduced to ruin when company executives stole most of the valuable assets from the firm. VBTRF's general director created a "closed stock company" called Super, to which he allegedly transferred fourteen of the company's fishing vessels (the ships had an estimated value of \$400 million). When the Russian government began investigating complaints by VBTRF's shareholders, the firm's general director and a number of other high-level officers resigned. VBTRF's general director then fled Russia for Seattle. A 1998 internal audit of VBTRF revealed that the firm's assets had dropped "by a factor of 10 since 1997." The shipping company had been almost completely looted, and the missing fishing vessels remained under the control of a Seattle-based firm managed by the son of VBTRF's former general director.¹⁸

Many other companies were established overseas to facilitate money laundering and asset stripping. These were usually affiliates or intermediaries in offshore zones.

Cyprus, a small, divided island in the Mediterranean without any natural resources or capital of its own, has become one of the largest investors in the Russian and Ukrainian economies. According to official data, Cyprus, which invested \$400 million in the Russian economy in 1999, ranked third only to the United States and Britain as a foreign investor.¹⁹ For example, in oil-rich Tiumen province, Cyprus invested only slightly behind the United States and Britain. Foreign investments in Tiumen were estimated to be \$1,141,800,000 by fall 1999. Most direct investment was in the oil and gas sectors. "The largest investors in Tiumen province economy were: USA—41% of the total investments; UK—37.5%; Cyprus—18%."²⁰ A very similar picture emerges in the structure of foreign investment in another highly invested area of Russia—St. Petersburg.

The United States was the leading investor in the first quarter of 1999 in the region, accounting for 51.8 percent (USD 68.8 million) of the total investment, with Finland in second place with USD 18.1 million (13.6 percent), followed by Cyprus registered companies with USD 12.6 million (9.5 percent) and Great Britain with USD 10.3 million (7.8 percent).²¹

Obviously, those investments were not made by Cyprus as a country but by offshore companies registered in Cyprus. Most of the direct "foreign" investment is Russian and Ukrainian money laundered to offshore zones and then redeposited in Russia and Ukraine as a foreign investment.

Asset stripping in the nonferrous metals industry, including illicit gold sales, nickel, and scrap metal from Russia, reaches several billion dollars a year. If we add skimming from the exports of oil, gas, military hardware, the fishing industry, and shipping the figure would rise to \$10 or \$12 billion a year. Russian government officials cite the figure of \$15 billion for 1999 and \$25 billion for 1998.²² The higher figure for 1998 is probably explained by the financial meltdown, and the desire of many to move their assets abroad. According to calculations of Russian experts, capital flight from Russia over the last five years has been at least \$60 billion.²³ Whatever total one accepts, there is no doubt that enormous resources have been shifted overseas by various means.

Laundering Money: Offshore Banking

In 1991, the term "offshore banking" did not relate to either Russia or Ukraine. Offshore banking was illegal and prohibited by the Communist Party. The only Russian banks or offshore companies that existed were created by the KGB for the benefit of the Communist Party. By 1996, however, the small island of Antigua in the Caribbean had four Russian banks and one Ukrainian bank registered.²⁴ Strict bank secrecy laws, nontransparent registration that does not require disclosure of the beneficiary owner, lax auditing requirements, and the ability to effect international currency transfers make Caribbean banking ideal for those who seek to avoid disclosure of the owners or the sources of revenue. According to a U.S. State Department report, "Private banking facilities, offshore banking, shell corporations, free trade zones, wire systems and trade financing—all have the ability to mask illegal activities."²⁵

In the Cayman Islands, 450 banks are registered with billions of dollars in

assets. Of those, 68 banks have actual offices. Although in the overall volume of offshore banking in the Caribbean the Russian and Ukrainian share is minuscule, those funds are often linked to criminal activities.

Under international pressure, by 1997 four out of five Russian banks in Antigua were closed. For example, a European Union Bank in Antigua was among those closed for fraudulent activities.²⁶ The bank had links to Kanonykhine, a Russian banker now residing in the United States, accused of embezzlement of \$6 million in Russia. Another is the All Russian Exchange Bank (Vserossiiskii birzhevoi bank), which also is identified as having links to Kanonykhine. In addition, several bank accounts and companies in the Caribbean have been traced to Pavlo Lazarenko former prime minister of Ukraine, who is charged with money laundering in the United States and embezzlement in Ukraine.²⁷

In addition to the Caribbean, a small nation of 10,000 in the Pacific, Nauru, became a major offshore Russian banking center. According to the Financial Action Task Force of the OECD, "In the Pacific region, a heavy concentration of financial activity related to Russian organized crime has been observed, specifically in Western Samoa, Nauru, Vanuatu and the Cook islands."²⁸ "American middlemen were reported to have opened accounts or chartered banks on behalf of the Russians."²⁹ Registering a bank is so simple in Nauru that 400 banks were registered to one post office box in just one investigation.³⁰ Tens of billions of dollars originated in Russia and went through offshore banking institutions in Nauru in 1998–99. A report from the Bureau of International Narcotics and Law Enforcement Affairs (INL) of the State Department noted:

Reports of the Central Bank of Russia in 1999 alleging that during 1998–1999 nearly 70 billion US dollars was either booked to Russian owned banks registered in Nauru or transferred through Nauru's correspondent banks to OFC [Offshore Financial Centers] in the Caribbean and Europe.³¹

What is the origin of these enormous sums and why do the Russian owners of the funds resort to offshore banks? The answer is obvious—to hide the money's source, usually to evade taxes or launder criminal money. However, money sitting in Nauru or the Cayman islands is useless unless it can be withdrawn for investment or consumption. At some point, funds are usually transferred from an offshore location to countries with real economies. Under U.S. law, once the transfers enter the United States, banking institutions must file a Suspicious Activity Report (SAR) if they detect signs of possible criminal activity. For example, if a normal and regular flow of payments is disrupted by an unusually large transfer, if a dormant account suddenly is used to wire a large sum of money, or

“American law enforcement and Russian Central Bank data leave no doubt that hundreds of billions of dollars in capital flight occurred via offshore banking.”

if modest company accounts wire extraordinarily large amounts of money in a short period of time, a U.S. bank would be alerted. Data on suspicious activity are accumulated in a national database. For the period January 1997 to January 1999, there were five hundred suspicious activity reports in the database relating to the countries of the former Soviet Union. According to an INL report:

National SAR database was searched to extract and then analyze SARs that include a reference to Russia or EEAE jurisdictions. An analysis of SAR filed during this period showed extensive large dollar wire transfer activity typically involving connections between multiple accounts, companies, banks and countries, often involving a Russia based bank or company or a Russian citizen.³²

The purpose of most of those transfers was not clear other than to keep the money moving and to make it difficult to track. This mechanism is known as layering, a process of numerous bank transfers to obscure the origin of the funds. Many SAR cases involve the movement of money to the United States from offshore jurisdictions and vice versa.

American law enforcement and Russian Central Bank data leave no doubt that hundreds of billions of dollars in capital flight occurred via offshore banking. The true owners of these funds usually seek anonymity for one of the following reasons:

- Hiding revenue from the Russian government to avoid taxation
- Hiding from Western creditors the assets of banks and companies (such as before the 17 August 1998 crash)
- Avoiding the risk of losing funds in international arbitration
- Laundering revenue of criminal enterprises, such as human trafficking, narcotics, trade, smuggling, and illicit exports

Capital Flight or Money Laundering

A question that has puzzled researchers, politicians, and law enforcement officials is whether any of the billions shifted from Russia overseas in the late 1990s was linked to organized crime. What part of the money was skimmed revenue parked in the West, and what part had its origin in criminal activity? The matter is complicated by the fact that many of the transfers abroad without permit may have violated Russian and Ukrainian laws but not Western ones. On the other hand, lack of laws governing economic activity in Russia and Ukraine would make certain deeds legitimate there that by Western standards are criminal. Those include insider trading, price fixing, kickbacks, and many others.

If we define criminal activity in a broad sense, including tax evasion, non-repatriation of hard currency revenues, or fraud, such as false contracts and other economic crimes, then a lion's share of Russian/Ukrainian money laundered or deposited abroad could be considered of illicit origin. However, if economic crimes are excluded from the definition, and only income from prostitution, contraband, extortion, human trafficking, narcotics, weapons trade, and the like is counted, then the share of criminal laundered money would be considerably reduced. In discussing money laundering from Russia, it is necessary to comment on the Bank of New York (BoNY) case.

Bank of New York Case

The Bank of New York case involves enormous financial flows out of Russia to various accounts at the bank, both directly wired through correspondent accounts in Russia and through companies set up in the West, especially Benex. The complexity of the case is in untangling who stood behind these financial flows, to what extent they were legitimate, and to what extent Western institutions were guilty of negligence or criminal violations.

It is useful to group the protagonists into three clusters. The first cluster includes those associated with Benex accounts at BoNY. The second cluster includes transactions laundered through the Caribbean bank accounts. The third cluster includes the accounts directly wired to and from Russian banks and companies.

The well-known facts of the case, reiterated in dozens of newspaper articles, all point to Benex, an offshore company, as a key mechanism for money laundering. Benex is managed by Peter Berlin for Simion Mogilevich, allegedly a notorious international mobster. Berlin is married to Lucy Edwards, who held a senior position in BoNY's East European Division. Initially, what caught the attention of British law enforcement was the volume of money being transferred through Benex to BoNY in England. They alerted American law enforcement, and in August 1999 the story was leaked to the *New York Times*.

Perhaps the most eloquent summary of the information received from the British was presented by Jonathan Winer, former deputy assistant secretary of state. He told the Banking Committee of the U.S. House of Representatives that he went to Britain to search for information on the flow of money through the BoNY. Winer said:

Additional information I received in the UK suggested that Benex's accounts at the Bank of New York included funds from drug smuggling, extortion, and contract killing. Benex thus appeared to be a part of the infrastructure in the US that the Mogilevich organization among others was using to launder the proceeds of serious crimes and to commit serious fraud.³³

Winer testified that in his view the BoNY case represented the largest money laundering operation uncovered to date. According to Winer, Benex moved \$4.2 billion in more than 8,000 transactions a month. He calculated that this meant an average of one wire transfer every five minutes had to occur every day for eighteen months.

It is now established that Benex served a variety of clients, ranging from the worst elements of the Russian mob to some of the most "important figures from the Russian financial community (sometimes called 'oligarchs')."³⁴

Much of the media attention focused on Mogilevich, Berlin, and Edwards. One article noted that Benex once tried to obtain a visa for Mogilevich to enter the United States.³⁵ The German press reported that Mogilevich was involved in dealing with stolen or embezzled international weapons sales from the Russian western army group as it was withdrawing from East Germany in 1993–94.³⁶ The Benex cluster of characters were also linked to Russian organized crime in Rimini, Italy, and a number of other places.

The second cluster of characters involved Natasha Kagalovsky (née Gurfinkel),

a high ranking BoNY officer and former Soviet citizen. Her husband, Kagalovsky, served as Russia's representative at the IMF and is currently a CEO of Yukos Oil (previously owned by Menatep Bank). This inquiry focused attention on the Bank of New York's mode of operation and some of its famous Russian clients. At the congressional hearing, Representative Leach asked the CEO of the Bank of New York: "Can you tell us first, is it true that the Bank of New York maintains accounts for Ms. Dyachenko [Yeltsin's daughter] in the Cayman Islands?"

Mr. Renyi: "We . . . by policy do not discuss relationships with any of our clients. . . . Obviously given the commentary in today's press what I can say is to confirm the fact that those two accounts do exist in the Bank of New York."

"The most important point of Renyi's testimony was that the Bank of New York claimed not to know the origin of the Russian funds."

Mr. Renyi also confirmed that the Bank of New York has established a subsidiary off-shore bank in the Cayman Islands. However, he explained that most of the money transfers were wired directly from corresponding banks in Russia, and that BoNY had no idea about the origin of the funds. He testified that BoNY basically handled the movement of

money to various accounts and that it made approximately a half-billion-dollar profit on the transactions in the period under inquiry. When asked by Representative Leach what that amount represented in terms of total profits from BoNY's wire transfer business, Renyi answered that it was about a fifth of BoNY business.³⁷ In other words, Russian business was a large share of BoNY's transaction operations.

The most important point of Renyi's testimony was that the Bank of New York claimed not to know the origin of the Russian funds. At minimum, this means that the bank was probably negligent in its SAR reporting and that some BoNY officials were colluding with questionable Russian businesses and/or organized crime figures. The second part of Renyi's testimony is that the bank wire transfers were sent directly from Russia. That means that the wire transfers had to have had a Russian Central Bank permit. If they did not, they clearly violated Russian law. Since the record of wire transfers is available, it should be easy to ascertain from Russian authorities whether the wire transfers were authorized.

The inquiry into BoNY's internal operations naturally led to two questions: How did this bank manage to establish itself on such a grand scale in Russia? Were there any other accounts or financial flows through the Caribbean jurisdictions? The answers to those questions has brought to the foreground the third cluster of characters, who are primarily associated with the Bank of New York-Inter-Maritime Bank and its chief owner, Bruce Rappaport.

The relationship between BoNY and Inter-Maritime is long and overlapping. Rappaport bought 8 percent of the Bank of New York in 1990. Shortly thereafter, BoNY bought 28 percent of the Bank Inter-Maritime, which was renamed BoNY-

Inter-Maritime. Bruce Rappaport held the single largest share of BoNY, and BoNY held the second-largest share of BoNY Inter-Maritime, with Rappaport holding the largest. The relationship between the two was close, according to Renyi. He acknowledged that BoNY used the same Moscow office space as the Moscow-based Inter-Maritime Bank. In other words, after Inter-Maritime Bank established a presence in Moscow, it then introduced the BoNY to Russian clients. The specific nature of business of a major Western bank in Russia is lack of business. They are not allowed to provide banking services to Russian clients other than in closely monitored state deals. The key to success in terms of expanding business in Russia was to establish a wide network of correspondent banks that would use BoNY as a conduit for Russian funds on the way out. In this venture BoNY succeeded more than any other bank.

Representative Leach asked Renyi: "Has Mr. Bruce Rappaport assisted Bank of New York in the past in developing clients or other business relationship in Russia or in Antigua?"

Mr. Renyi: "I can say that there has not been any involvement with Mr. Rappaport with regard to our Russian efforts. I think, as it was reported in the press, he assisted us in establishing our presence in Russia."³⁸

Rappaport denied any connection to BoNY's clients in Russia but various reports present a different story. Many journalists and analysts all over the world scrutinized Rappaport's contacts in Russia. A German paper wrote that Bruce Rappaport knew Gurfinkel (Natasha Kagalovsky) in the early 1990s and met with people in her circle, including Kagalovsky, one of the key bankers, and Chubais, the privatization tsar.³⁹ *Le Monde* reported:

l'un des contacts de la bank of New York avec les clients russes etait l'un des principaux actionnaires de la bank of New York-Inter-Maritime en Suisse Bruce Rappaport. [One of the principal shareholders of the BoNY-Inter-Maritime of Switzerland, Bruce Rappaport served as a key contact for the BoNY with their Russian clients.]⁴⁰

The *New York Times* also wrote that Rappaport played a key role in bringing together BoNY and various Russian clients.⁴¹ All sources indicate that Rappaport established his base in Moscow in the early 1990s with exactly the same people who played key roles in the early days of Russian banking, privatization, and foreign trade. That fact in itself does not necessarily point to any wrongdoing. It is only natural for a Western banker to introduce himself to the banking circles of young capitalist Russia. However, a German report suggested that the relationships struck in the early 1990s were not totally benign. The report called him a key figure in the BoNY scandal, because Rappaport,

at the beginning of the 1990s, was already active as a banker in Moscow. . . . Already then he offered to the leading politicians in Moscow to open their accounts in New York and to transfer there any sum of money they would want and from any place also.⁴²

The fact that Tatiana Dyachenko did have an account with the BoNY in Cayman Islands suggests that this offer was taken seriously and that some very prominent Russians used Rappaport's important connections to the BoNY.

Dyachenko's salary as President's Yeltsin's image maker would hardly have generated amounts to warrant an account in Cayman Islands. Inter-Maritime Bank, through its good offices with the BoNY, became part of the network of relationships with Moscow's financial elite. More troubling was a report that Inter-Maritime had Benex as one its clients.⁴³

Bank of New York-Inter-Maritime had a questionable reputation. In 1998, the U.S. Department of Justice tried to seize the proceeds of a money-laundering account at the BoNY-Inter-Maritime in Antigua. The bank refused to cooperate on the grounds that it had already surrendered the millions of dollars to the Antiguan government. It is noteworthy that Mr. Rappaport was Antigua's ambassador to Russia.⁴⁴ Jonathan Winer went even further in his testimony: "Inter-Maritime bank linked to Swiss American Bank, an Antiguan Bank handled a variety of criminal accounts including for Russian organized crime."⁴⁵

In summary, the first cluster of characters revolves around London and Rimini and has links with Mogilevich and other unsavory criminal elements. The second cluster revolves around New York and direct wire transfers from Russia, including on-shore and offshore mechanisms on both sides of the Atlantic that made it possible. The third cluster of characters revolves around the Caribbean, and includes Dyachenko, as well as Kagalovsky in his capacity as Yukos oil company executive with offshore holdings.

Although this does not explain who exactly sent how much, it does help explain why so much money was moving through the accounts of the BoNY. Some of it was clearly criminal (Benex accounts); some of it was related to high-level public corruption (Dyachenko); and some of it was seemingly legitimate money in search of a safe haven to avoid taxes or hide profits (Yukos).

Conclusions

Russian crony capitalism is a Soviet phenomenon reincarnated under a new "Western" economic umbrella. As under Breznev, its most prominent feature is still defrauding the state. The only thing that has changed is that defrauding the state is easier because the Russian state is now weaker. There are no longer enforceable rules or institutions. The laws did not evolve as fast as the changing economic reality.

Russian crony capitalism began with criminalization of the privatization process and is as detrimental to Russia's development as Brezhnev's brand of socialism was. At least under Brezhnev more of Russia's capital remained in the country, which enabled more of the population to enjoy a higher standard of living. Crony capitalism generates not the economic growth and prosperity expected from market reforms but economic stagnation, degradation, and the pauperization of the country.⁴⁶ It also generates criminal political networks that pose a real threat to democratic development and the international community.

In the final analysis, Russia's asset-stripping, shifting assets overseas, and money laundering have very little to do with a market economy, as there are no real economic markets in Russia today—at least not by Western standards. State supported industries continue to produce losses and stifle competition and entre-

preneurship. The enterprises continue to engage in barter and fraudulent bankruptcy. Perhaps the only thing that has changed is that stealing from the state, a centuries-old practice in Russia, has grown new criminal wings as it is facilitated by legal offshore companies and naïve or complicit Western institutions. The remedies are obvious: the plunder of assets has to stop, and offshore jurisdictions have to strengthen know-your-customer rules or face sanctions. Russian and Ukrainian governments must enact laws against money laundering, as well as tax reform to attract investment and capital back home.

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