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INTRODUCTION

Our topic is cooperation with the private sector.

Yesterday, I spoke about a case in which \$230 million in stolen funds was laundered through a myriad of shell companies and financial institutions, all without being detected by anyone in the private sector.

- Indeed, the private sector's role was to create the shell companies through which the beneficial ownership and the source of the funds being laundered could be disguised
- And then to facilitate the conversion of the laundered funds into real estate investments in New York.
- That was the Prevezon case, which involved \$230 million in funds stolen in Russia, laundered through banks in Eastern Europe, and invested in the United States.

Today, I want to talk about two other money laundering schemes, also involving funds that originated in Russia, that further illustrate the role of shell companies in money laundering schemes, the need for greater transparency, and the need for greater vigilance on the part of the private sector.

- I'm speaking about the scheme known as The Russian Laundromat and the scheme known as the Mirror Trading Scheme

- From this, I hope to draw some lessons and some suggestions that might help to frustrate or impair similar money laundering schemes going forward.

The Russian Laundromat

“The Russian Laundromat” is the term given by the media to a scheme for laundering the proceeds of Russian criminal activity through shell corporations and European banks that flourished from 2010 to 2014.

How It Worked

Russian businesses controlled by oligarchs with ties to the Russian state and to Russian organized crime amassed billions of dollars in illicit proceeds in Russian banks

- and needed a means of creating the appearance that the money came from a legitimate source.
- According to media reports, the money derived from a variety of illegal sources, including
 - contract fraud (such as inflated payments on contracts with the Russian state),
 - tax evasion and tax fraud,
 - embezzlement from Russian banks and other corporations, and
 - generic organized crime (such as drug trafficking and human trafficking.).

To launder the money, a Russian business holding criminal proceeds would create two shell corporations,

- and would create paperwork that made it appear that one of those corporations owed money to the other.
- The Russian business would then guarantee the “debt,” so that when one of the shell corporations “defaulted” on the “loan” to the other, the Russian business would be liable to pay it.

Each of the Russian businesses included a Moldovan citizen as a responsible party so that when the “default” occurred, the shell corporation seeking payment could resort to the Moldovan courts.

- With the cooperation of corrupt Moldovan judges, the shell corporation would obtain a court order directing the Russian business to pay the debt to an account at a Moldovan bank.
- Complying with the court order, the Russian business would transfer the criminal proceeds being laundered to the Moldovan bank,
- at which point the shell corporation receiving the money was free to disburse it anywhere in the world to pay for whatever assets the beneficial owners of the shell corporation wished to acquire.

Because the money was deposited into the Moldovan bank pursuant to a court order, it acquired the appearance of legitimacy,

- and because the ownership of the shell corporations was not disclosed (either to the Moldovan bank or to the banks to which it transferred funds), the transactions provided a degree of anonymity to the persons conducting the transactions.

According to the media reports, at least \$20.8 billion was laundered in this fashion

- and was used to make investments, purchase luxury items, and acquire merchandise imported by Russian companies from Western sources.

Here’s the key point:

In many cases, the success of the scheme depended not only on the role played by a corrupt judge

- and not only on the lack of transparency afforded the shell companies when they used the banks to move their money,
- But also on the willingness of the vendor of the goods and services to receive payment not from the purchaser directly
- but from a company whose beneficial ownership was unknown either to the vendor or to the bank processing the payment on the vendor’s behalf.

“Mirror Trading”

My second example is the “mirror trading” scheme

That was the name given to a method of moving large sums of money out of Russia and into Western countries by means of making parallel trades in securities.

- It was used to expatriate flight capital, engage in tax evasion, and (in all likelihood) to launder criminal proceeds.
- Here’s how It worked

A broker representing two companies with common ownership – one in Russia and one elsewhere – would approach the trading desk at a major international bank such as Deutsche Bank and ask to make two more or less simultaneous trades.

- The Russian company, the broker would say, wants to buy a large quantity of stock in a publicly traded company for \$10 million,
- while the foreign company wants to sell an identical quantity of the same stock in a Western country such as the UK for around the same price.
- Because the two trades are the mirror image of each other, this process is called “mirror trading.”ⁱ

To process the trade, the trading desk in Moscow would handle the Buy Order with funds provided by the Russian company,

- while the corresponding trading desk in London or another location would process the Sell Order,
- depositing the proceeds of the sale into whatever account in the United Kingdom or elsewhere that the broker or his client might designate
- typically such trades would be of a magnitude of roughly \$10 million.

Mirror trades make no economic sense:

- even if the client could avoid selling the stock on the foreign exchange for less than the purchase price in Moscow (a loss that is hard to avoid),

- the client would suffer a loss merely from having to pay the commissions of the various intermediaries, including the international bank and the Russian broker.
- Because the purchase occurred in Russia and the sale occurred elsewhere, however, the effect of such trades is to move large sums of money out of Russian and into Western countries.

In the above example, the effect of the two trades would have been to move \$10 million (minus fees) from Russia to the United Kingdom or another Western country,

- and to convert it from rubles to pounds, euros or dollars.
- Between 2011 and 2015 when such trades at Deutsche Bank were discovered and discontinued, Deutsche Bank alone processed \$10 billion in such trades.

The Failure of Oversight by Financial Institutions

The apparent willingness of clients to lose money repeatedly on seemingly meaningless trades should have alerted financial institutions such as Deutsche Bank handling these transactions that their clients were engaged in the expatriation of flight capital, if not something more serious in nature.

- The employees at the trading desks who handled the trades on a day-to-day basis would also have been aware that the supposedly distinct clients engaged in the mirror trades were represented by the same broker
- and had overlapping or common ownership.
- Yet neither Deutsche Bank nor any of the other international banks processing mirror trades between 2011 and 2015 reported them to the appropriate authorities
- or ceased making such trades on their own.

I should add that the mirror trading process was likely just one component of a much larger movement of Russian capital to the West.

- According to a paper published in 2015, roughly 18 billion British pounds flow into the United Kingdom each year, a large portion of which

represents Russian flight capital or criminal proceeds from Russian sources.ⁱⁱ

- Moreover, the authors report that a large portion of the inflow of hidden capital enters the United Kingdom through the securities market, with the assets often held by shell companies whose beneficial owners are not known.ⁱⁱⁱ

COMMON ELEMENTS AND RISKS

These cases reveal several recurring, common elements that allow such schemes to flourish.

1. The use of shell companies formed in jurisdictions that do not require the identification of the beneficial owners of the companies or their assets.
2. Lax AML compliance by financial institutions, and the inability or lack of motivation of such institutions to detect innovative ways of conducting transactions involving illicit funds.
3. The willingness of vendors and their financial institutions to accept payments for goods and services from third parties with no apparent connection to the purchaser of the goods and services.

These cases also expose some obvious risks to developed countries and their economies:

- Broadly stated, there are at least three principal concerns.

1. Surrendering the “high ground”

When they allow their financial institutions and providers of goods and services to be used as conduits for the proceeds of corruption, tax evasion, fraud, capital flight, and organized crime from the less developed parts of the world,

- Developed countries wittingly or unwittingly facilitating criminal activity in the developing world and the diminution of the resources available in those countries to improve health, education, and infrastructure.

- No nation wants to be perceived as the repository of the world's criminal proceeds, or as a facilitator of crimes committed at the expense of the impoverished citizens of the developing world.

2. Prevention of new criminal activity

Second, a system that moves money through anonymous entities for the purpose of concealing the proceeds of past criminal acts can, once it is up and running, be used as easily to facilitate the commission of new crimes,

- such as financing terrorism, acquiring arms and explosive materials, and sending money to rogue states in contravention of international sanctions.^{iv}
- It is as important for nations to prevent the use of their financial systems to facilitate the commission of future criminal acts as it is to prevent them from being used to conceal the source or ownership of crimes that have already occurred.

3. Threats to national security and the integrity of institutions

Third, the infusion of criminal proceeds into a developed Western economy can provide criminals and criminal organizations with undue influence that may be used to

- corrupt public officials,
- influence the electoral process, or
- purchase controlling interests in important industries or real estate in major cities.

Allowing anonymous persons to acquire controlling interests in institutions, industries and physical assets presents a threat to national security

- and skews the economy in favor of persons with access to huge sums of untaxed cash to the detriment of would-be competitors in the marketplace who lack access to such resources.

RECOMMENDATIONS

Among the many things that we have all said should be done to address these concerns, I would emphasize the following:

1. Increase the awareness among vendors, financial institutions, and professionals -- including attorneys, real estate agents, financial advisors, insurance agents and securities dealers -- of the risks of accepting third-party payments,
 - and of the consequences (including criminal prosecution and asset forfeiture) of doing so
2. Prohibit companies that protect the anonymity of their beneficial owners from moving funds through domestic financial institutions, acquiring fixed assets or significant interests in businesses, or paying for goods for export, without revealing the identities of the real parties in interest
3. Make it part of the Know Your Customer requirement that financial institutions know when a customer is acting on behalf of a third party and who the third party is.

There are many other things that could and should be done, but requiring greater transparency is a good place to start.

ⁱ This example is taken from Ed Caesar, “Deutsche Bank’s \$10-Billion Scandal,” *The New Yorker*, 29 August 2016.

ⁱⁱ Oliver Harvey and Robin Winkler, “Dark matter: the hidden capital flows that drive G10 exchange rates,” (9 March 2015), quoted in Caesar, *supra*.

ⁱⁱⁱ Oliver Harvey and Robin Winkler, “Dark matter: the hidden capital flows that drive G10 exchange rates,” (9 March 2015), quoted in Caesar, *supra*.

^{iv} Some policy makers appear to be aware of this problem. For example, Rep. Sheila Jackson Lee (D-Tex.) has called for an investigation into whether the money stolen in the Moldovan bank embezzlement scheme was used to finance terrorism.