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NOTES & *études*

Money Laundering in Cyprus
An assessment

Money Laundering Series
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Mai 2007

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Notes & *études* du Département de recherche sur les Menaces Criminelles Contemporaines
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MONEY LAUNDERING IN CYPRUS: AN ASSESSMENT

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EXECUTIVE SUMMARY

This report reviews in detail the steps taken by Cyprus to curb money laundering and financial crime, and to contrast it with the continued existence of legal loopholes and systemic weaknesses that groups and individuals are able to exploit for criminal purposes. Despite the country's successes in achieving a high level of AML compliance, inconsistent application and enforcement of standards casts a pall over the island's otherwise improving record. Examples of lax AML implementation and enforcement, and resulting criminal activity are found in a number of Cyprus money laundering case studies included in this report. Further, this report identifies the remaining weaknesses in Cyprus' AML regime. Cypriote, EU, and international monitoring and enforcement resources and capabilities should be focused on addressing these weaknesses in order for Cyprus to reach the highest international AML standard.

In the 1990s, Cyprus was generally acknowledged to be one of the world centers for money laundering. Lax banking laws and tolerant supervisory and enforcement attitudes and policies allowed Cyprus to become a haven for a wide range of illicit financial transactions, especially involving criminal networks from Russia and the former Soviet Union, Eastern Europe, the Balkans and the Middle East. At the same time, there was an odd deniability by Cypriote government, and enforcement and financial industry officials and leaders, appear reluctant to acknowledge the indisputable evidence, or to candidly assess the nature and depth of this illicit conduct. The fact that Cypriote officials continue to minimize the island's recent history, rather than confront directly the attitudes and practices that allowed illegal money laundering to flourish, creates skepticism about their ability to now grapple with these underlying conditions, many of which may still exist despite recent efforts to mitigate the island's exposure and vulnerability to financial crime.

In recent years, as Cyprus prepared for its 2004 accession into the EU, the government enacted a robust anti-money laundering regime compliant with international technical standards. There is no question that on a purely technical basis, Cyprus has taken the steps needed to install stronger protections against money laundering and other financial crimes. In a clear effort to meet EU standards and improve its image as a modern and performing financial center, Cyprus has acted with speed and clarity.

But while an entirely new legal and regulatory regime has been crafted and installed in less than a decade, lingering doubts remain about the supervisory and enforcement structure needed to police these new rules and to make them truly effective in practice, and whether these bodies have the expertise, resources and commitment to bring the actual workings of its complex financial system up

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to EU and international standards. Implementing and enforcing AML international standards has strained Cyprus' oversight and monitoring resources. While Cyprus has complied with the requirements on paper, in reality their effectiveness in detecting and punishing financial criminal activity remains limited.

This report identifies several specific areas in which Cypriote AML authorities should focus to significantly strengthen compliance and oversight:

- **Inconsistent monitoring and oversight of non-bank financial services/transactions**

Internal AML regimes of banks are sophisticated and closely monitored by the Central Bank of Cyprus, while the level of detection and reporting of suspicious transactions in the non-banking financial sector remains very low. As a result, the AML regime has not been consistently designed, applied and enforced across all relevant financial institutions and professionals.

- **Uncertain commitment of non-bank financial professionals to AML requirements**

Increasingly, money launderers seek out the advice and services of specialized legal and financial experts. However, these professional experts have not been a major source of suspicious transaction reports despite their critical role in them. Until these service providers evidence compliance with AML requirements, Cyprus' overall AML regime will continue to have a critical weakness. (See Case Study 3: Milosevic and excerpt from the Global Witness report quoted in Case Study 10: The "Gas Connection").

- **Insufficient due diligence on beneficial ownership of companies and trusts**

Trust and company service providers (except international trust companies) are not yet required to apply customer identification, record keeping, internal reporting, and other AML procedures. Significantly, the "majority" of customers establishing companies and trusts in Cyprus appear to be non-residents. Customer due diligence in such cases is more challenging, identification of beneficial ownership is difficult, and verifying the consistency of non-resident financial transactions is a complicated task. (See intricate structures shielding assets related to Yukos and Khodorkovsky in Case Study 7).

- **Ineffective control of legal persons**

The registration process is of a formal nature and no material checks are carried out to ensure the correctness of the information submitted. For example, there are no legal measures to prevent a physical person convicted for an offence, such as money laundering, committed through a legal person, from carrying out further business through legal persons or from acting in a leading position within a legal person. Therefore, legal persons can rather easily be used to shield further criminal activity. (See "mafia godfather" Mogilevich's possible control of Cyprus-registered companies in Case Study 4, and Case Study 10: The "Gas Connection").

- **Strained resources for oversight and due diligence of legal persons**

The size of Cyprus' companies and trusts industry raises issues about oversight bodies' screening and monitoring capacities. Performing due diligence duties is all the more difficult as most customers are non-residents. Moreover, checking existing thousands of international business enterprises registered over time in the Registrar of Companies is a huge task. It is unclear whether Cypriot authorities have carried out a truly exhaustive review of existing legal entities and confirmed the customer information. (See Case Study 9: Suspicious Wire Transfers Schemes Between the United States and Cyprus and other case studies mentioning the role of Cyprus-registered companies).

- **Weak sanction regime to punish AML non-compliance**

According to international obligations agreed to by Cyprus, the whole policy of sanctions for persons failing to comply with the AML legislation should be "effective, proportionate and dissuasive". Cyprus' sanctions for money laundering are not. Fines are low and the Central Bank of Cyprus has never fined institutions under its supervision for failure to comply with the legislation. Instead, the Bank sends letters containing recommendations for corrective action. In the same way, Cyprus' law enforcement attitude towards money laundering is rather lenient. In 2001, there were two investigations for negligent money laundering, but neither resulted in prosecution and there has been little activity targeting lawyers for money laundering offences.

- **Poor performance of law enforcement reporting entities and insufficient legal action**

Although the legal basis to enable successful investigations and prosecutions for money laundering is satisfactory, the effectiveness of law enforcement in using it is unsatisfactory. A close review of statistics show that there are few money laundering cases successfully prosecuted compared to the size of Cyprus' financial sector, and convictions obtained have been for domestic money laundering (relatively basic cases). In other words, money laundering prosecutions appear to target the relatively "easy" cases of self-laundering (e.g., laundering one's own proceeds) with domestic predicates. Meanwhile, major investigatory proceedings and press accounts in other jurisdictions continue to reveal the depth and complexity of these illegal financial manipulations in Cyprus, many of which implicate Russian criminal syndicates, whose extent is not yet fully known or understood. The distinct lack of any high profile enforcement cases in Cyprus is worrisome and suggests continuing weakness and vulnerability of the regulatory regime.

The coming years are crucial to proving Cyprus authorities' commitment and willingness to safeguard the island from criminal activity, shady deals, and suspicious customers as well as to successfully prosecute increasingly complex money laundering cases. Tweaking the system, closing loopholes, and improving its record of enforcement will move Cyprus from being compliant to AML regulations to playing an active role in the global effort to combat money laundering.

Strengthening AML compliance and enforcement is particularly relevant given Cyprus' impending membership in the European Monetary Union ("EMU"). Full membership in the EMU will provide opportunities for money laundering insofar as Cyprus' vast range of financial services offerings to sophisticated and international clients, and an internationally-used domestic currency, proves attractive to individuals and entities searching to recycle the proceeds of organized crime activities. International transactions carried out in US$ and Euros can go undetected, and assets in hard currencies are exempt from devaluation risks and are instantaneously transferable to any jurisdiction in the world.

MONEY LAUNDERING IN CYPRUS: AN ASSESSMENT

Although generally compliant to internationally recognized and evolving anti-money laundering standards (notably FATF 40 + 9 Recommendations and EU Directives), Cyprus has a history of dubious offshore entities and transactions that cast a shadow on the effectiveness of AML implementation. Cyprus' thirst to join the European Union has undeniably driven the country to pass and enforce legislation to combat financial crime and corruption. While the government has technically complied with anti-money laundering ("AML") requirements, and has never been on the FATF list of non-cooperative countries and territories, enforcement continues to be questionable.

Today, the biggest challenge for Cyprus is to bring existing legal entities up to the standards of transparency imposed by the new legal and regulatory framework, in particular with respect to the identification and confirmation of beneficial ownership. To this effect, colossal human and financial means are required to screen closely the ongoing registration procedures, as well as to investigate previously established businesses.

Secondly, Cyprus' law enforcement community will have to prove itself capable of dealing with complex money laundering cases, many of which involve transnational components that require mutual legal assistance and coordination across foreign jurisdictions. So far, almost all successful prosecutions of money laundering cases in Cyprus have involved basic schemes and domestic predicates. High-profile money laundering cases will undoubtedly come up in the coming years if the Cypriote law enforcement is to demonstrate its effectiveness.

This report reviews Cyprus' continued exposure to money laundering despite its AML efforts. Based on an analysis of environmental factors (economic, financial, criminal) and an in-depth assessment of the AML regime, deficiencies and loopholes in Cyprus' implementation and oversight of requirements will be underscored. A detailed discussion of issues arising from loopholes in beneficial ownership requirements is provided. In addition, the paper provides an assessment of the consistency of the application of AML requirements across financial sectors and professionals, with a special focus on weaknesses in implementation and monitoring for non-banking institutions and professionals. Some of these non-banking professions are also self-regulated and likely constitute a weak link in the chain of players working to prevent, detect and punish money laundering.

1. Overview of the Economic, Financial, and Criminal Environment in Cyprus

- ***The Cypriote Economy and Measures of Corruption***

The Greek Cypriote economy is modern and predominantly service-based: services as a whole account for approximately 76% of GDP. Tourism accounts for 25% of the GDP and financial services for 7%.

Cyprus began operating as an offshore financial center in the late 70s, relying on tax treaties with 40 countries (including the United States, Russia and former USSR nations, India and China) to allow for the provide shelter from double taxation and to provide very attractive low corporate profit tax rates (4.25% until the end of 2005). The island has a long-established capitalist economy and the business

services sector has been growing for the last twenty years. Despite the increase in taxes and tightened business and financial regulations resulting from EU accession, international companies and business are expected to continue to be attracted to Cyprus. Companies will continue to seek out opportunities in Cyprus for three primary reasons: first, the corporate tax rate of 10% is very low compared to other EU member rates; second, the island still maintains non-double taxation treaties; and third, EU accession brings growing prospects of prosperity.

There is little doubt that Cyprus remains an international business hub. Cyprus has benefited from its central Mediterranean location and also from political stability. These two factors have helped the island attract business and funds from the Middle East (e.g., the civil war in Lebanon diverted business from this formerly important financial center to Cyprus), as well as from Eastern Europe, the Balkans, Russia, and countries of the former Soviet Union.

Cyprus is also cultural hub, with a mixed population of people of Middle Eastern and European descent. Immigration policy and visa requirements are liberal. Russians form the island's largest expatriate community, with an estimated 35,000 Russian residents based around the port of Limassol. Street signs in Russian stand alongside Greek and English, Italian and some French ones.

EU Accession

Cyprus became a member of the European Union in May 2004. EU accession has sped economic liberalization and the country is preparing for 2008 membership in the European Monetary Union ("EMU"). The Cyprus Pound has been pegged to the ECU since 1992 and to the Euro since 1999. A consequence of accession to the EU was the replacement of a strict exchange control regime under the Exchange Control Law by the Capital Movement Law enacted in 2003.

Also as a result of EU accession, regulations and paperwork related to corporate law have been streamlined making it still very easy to establish a business in Cyprus. Existing regulations affecting business are transparent and applied with consistency. Most capital restrictions and limits on foreign equity participation and ownership have been lifted and EU investors, as well as non-EU investors, may now invest freely in most sectors[1]. Given the context, this development is likely to allow organized crime to diversify activities and use Cyprus' business environment not only to recycle proceeds of criminal activity, but also for the investment of laundered money in sectors of interest to provide a logistical basis for illegal trafficking (transportation infrastructure, international trade, etc.).

Full membership in the EMU will provide opportunities for money laundering insofar as Cyprus' vast range of financial services offerings to sophisticated and international clients, and an internationally-used domestic currency, proves attractive to individuals and entities searching to recycle the proceeds of organized crime activities. International transactions carried out in US$ and Euros can go undetected, and assets in hard currencies are exempt from devaluation risks and are instantaneously transferable to any jurisdiction in the world.

Corruption

Cyprus ranks 37th out of 158 countries in Transparency International's Corruption Perception Index for 2006, which ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. The country is a democracy generally considered to be functioning well although there are reportedly "customer-provider" type of relationships ("clientelism") between political parties and their voters. Civil servants can be over-deferential vis-à-vis political figures and their families. That said, law making is managed by democratically elected politicians and there is an independent judiciary. The media is legally free to expose corruption and criticize those who misuse power. Public administration and its regulatory framework are well-defined in the Constitution as well as in Public Service Law, laying the groundwork for sound governmental administration.

The country has a comprehensive legal and administrative framework in place against corruption, and both active and passive corruption[2] are criminalized. In 2003, Cyprus established the Coordinating

[1] Sectors subject to limitations are mass media and tertiary education. Non-resident purchase of real estate is subject to approval by the Council of Minister.

[2] Active corruption is the deliberate action of whosoever promises, offers or gives, directly or through an intermediary, an undue advantage of any kind whatsoever to a person, for himself or for a third party, in the

Body against Corruption, tasked with an advisory role on anti-corruption domestic policy developments (although interestingly without a targeted mandate or clear mission). The Body is also in charge of "raising public awareness on the dangers of corruption and of promoting co-operation between public authorities and the private sector" in this field. Through these initiatives, Cyprus is apparently moving to upgrade the general business environment, thereby reducing the possibility of negligent white collar fraud and crime (including laundering proceeds of corruption).

- ***The Cypriote Financial Sector***

Cyprus' financial industry is clearly still exposed to money laundering as the range of financial and business services offered on the island is wide, and the players numerous and disparate enough for would-be money launderers to shop around according to their needs and means. While EU accession has brought about new compliance requirements for the entire financial sector – including in the AML field – the resulting new obligations have strained supervisory resources and challenged the skills of management and supervisors.

Cyprus' financial sector is diverse and generally considered to be relatively sound. EU accession has generated economic reforms, thereby liberalizing the economy and increasing regulations. Restrictions on the scope of domestic operations have been lifted and in 2005, fiscal differences between domestic and offshore institutions were eliminated. Four authorities regulate and supervise financial institutions in Cyprus: the Central Bank of Cyprus, which is responsible for supervising locally incorporated banks as well as subsidiaries and branches of foreign banks; the Cooperative Societies Supervision and Development Authority ("CSSDA"), which is responsible for the supervision of cooperative credit institutions; the Insurance Companies Control Service Superintendent; and the Cyprus Securities and Exchange Commission ("SEC").

In 2005-2006, the International Monetary Fund conducted an assessment of Cyprus' financial sector supervision and regulation functions. The subsequent report, which was released in October 2006, stated that "supervision of international banks and domestic commercial banks, already found to be very competent in the assessment of 2001, has progressed to reach high standards, although additional resources are recommended[3]". The report noted that continuing EU accession work is substantially increasing the supervisory workload and the complexity of supervisory tasks and responsibilities. The IMF report suggested Cyprus appoint additional specialized staff to deal with prudential issues (internal risk systems and models, financial stability analysis, expanded cross-border supervision).

Banks:

Banks doing business in Cyprus are classified into two categories – domestic banks, and International Banking Units[4] ("IBUs," also formerly known as offshore banks) – although differences between the two are diminishing as a result of EU accession. With Cyprus' accession to the EU, banks licensed in EU countries can establish branches in Cyprus and can provide banking services on a cross-border basis under the European Union's "single passport" arrangement (i.e. without having to obtain a license from the Central Bank). By the end of 2006, four foreign banks were operating in Cyprus under this arrangement. That said, as of January 1, 2006, there is no longer any distinction between domestic and international banks, as they now both have to comply with the same legal, administrative, and reporting rules and are subject to the same tax regime (10%). Both domestic and international banks are placed under the supervision of the Central Bank of Cyprus and are subject to on-site and off-site examination. These changes have helped drive the harmonization of internal AML regulations across banks.

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course of the business activities of that person in order that the person should perform or refrain from performing an act, in breach of his duties. Active corruption or 'active bribery' is the offence committed by the person who promises or gives the bribe. On the contrary, 'passive bribery' is the offence committed by the official who receives the bribe. Active bribery is the supply side, passive bribery the demand side.

[3] Cyprus : Assessment of Financial Sector Supervision and Regulation, including Reports on the Observance of Standards and Codes on the following topics : Banking Supervision, Insurance Supervision, and Securities Regulation. IMF, October 2006. Paragraph 36.

[4] IBU is a descriptive term which denotes a foreign owned bank operating in Cyprus with a license obtained from the Central Bank

Cyprus hosts a total of forty banks: 14 are incorporated locally and 26 are foreign-incorporated IBUs. Among locally-incorporated banks, there are three specialized financial institutions and eleven domestic commercial banks which operate a network of 467 branches across Greek Cyprus, with total consolidated assets of about US$ 53.9 billion (as of August 2006). The three largest domestic banks are the Bank of Cyprus, Cyprus Popular Bank ("Laiki") and Hellenic Bank.

The 26 IBUs operating in Cyprus are estimated to have total consolidated assets of US$ 22.8 billion (as of August 2006). The largest IBUs are Kommunalkredit International Bank Ltd. (Austria), DePfa Investment Bank Ltd. (Ireland), Russian Commercial Bank Ltd. (Cyprus), Crédit Suisse First Boston Ltd. (Cyprus, Switzerland), and Barclays Bank PLC (United Kingdom).

In the 90s, most of these banks have been involved in money laundering cases which are discussed as case studies in a subsequent section of this paper. The banks were frequently implicated for receiving funds or processing transactions without confirming the origin of the funds. These transactions typically occurred before any AML framework was in place, or in the early years of the Cypriote AML regime. As a result of various money laundering scandals, in the late 1990s the Central Bank of Cyprus revoked a number of banking licenses. In November 1998 and June 1999, the banking licenses of the Cyprus branches of Inkombank and Menatep of Russia were revoked following similar action by the Central Bank of the Russian Federation (see Case Studies 5 and 6). In May 2000, the Central Bank of Cyprus ordered the closure of the Nicosia branch of Beogradska Banka, a state owned Serbian bank closely linked with President Slobodan Milosevic (see Case Study 3), on grounds of insolvency.

Shell banks are prohibited in Cyprus. IBUs must have a physical presence on the island. Cypriote authorities claim to have become very selective in terms of which banks they allow to operate on the island, claiming they accept only banks from jurisdictions with high anti-money laundering standards. At the same time, no specific legal provision prevents Cypriote banks from engaging in correspondent banking relationships with correspondent banks that do not apply the same AML standards. In other words, there are no laws or guidelines requiring financial institutions to confirm that correspondent financial institutions in a foreign country do not permit their accounts to be used by shell banks. The Central Bank of Cyprus has indicated that it is in the process of revising Guidance Notes to Banks to clarify this issue.

Other Financial Services Entities:

Cyprus' AML efforts have focused on regulating banking activity, but the island is also home to a significant number of other financial services entities vulnerable to money laundering. Apart from banks, the Cyprus financial sector also comprises:

- 6 money transfer companies (supervised by the Central Bank of Cyprus)
- 47 investment firms + 2 Undertakings for Collective Investment in Transferable Securities ("UCITS" are management firms supervised by the Securities and Exchange Commission)
- 70 "International Financial Service Companies, including 40 independent financial advisers ("IFCs" are supervised by the Securities and Exchange Commission and independent financial advisers provide investment advice but do not hold client funds)
- 362 credit institutions (supervised by the Cooperative Societies Supervision and Development Authority)
- 43 licensed insurance companies (supervised by the Insurance Companies Control Service)
- 6 International Trustee services Companies ("ITCs"). Aside from ITCs, the large majority of domestic trust and company providers are lawyers.
- 200 feeder funds (wholly owned subsidiaries of overseas collective investment schemes)

The geographical breakdown of financial institutions' customer bases vary according to the type of products and services the institution offers. Statistics on customer based are unavailable but AML

evaluators sent to Cyprus by the Council of Europe in 2005 conducted field interviews on this issue[5]. The "vast majority of customers" in the investment and insurance sectors are Cypriotes residing in Cyprus. A "significant majority" of customers of the banking sector appear to be Cypriotes resident in Cyprus, with a "significant minority" of Cypriote expatriate customers. A minority of customers across the financial sector as a whole "seems to originate" from the EU (with a predominance of Greek and British nationals), the Middle East and South Africa. Significantly, the "majority" of customers establishing companies and trusts appear to be based outside Cyprus. Customer due diligence is always more challenging in the case of non-residents, the identification of beneficial ownership can be very difficult, and the verification of the consistency and nature of financial transactions conducted between the institution and client is difficult to assess. These factors indicated that companies and trusts are the most exposed to money laundering.

Overview of AML Oversight Across the Financial Sector

In Cyprus as in all countries with AML regimes, the banking sector's awareness to money laundering risk emerged earlier than did awareness among non-bank financial institutions (i.e. insurance companies and brokers) and other financial and business professionals ("gatekeepers"). Historically, banks have been the first to develop comprehensive internal AML regimes for prevention and detection purposes in order to comply with requirements imposed by foreign jurisdictions where they operate branches and subsidiaries, as well to comply with their country of origin's legislation. In recent years, the Central Bank of Cyprus has introduced many new regulations aimed at enhancing anti-money laundering vigilance in the banking sector by placing significant new obligations on banks (in particular, regarding their customer policy).

AML oversight across the financial sector is inconsistent: there is surely a distinction to make between banks who are closely monitored by the Central Bank of Cyprus and whose AML internal regimes address the issues of customer due diligence and the identification of beneficial owners, and the rest of the financial services industry. First, as previously stated, the AML regime that is typically applied within banks is more sophisticated than the regimes applied to other financial institutions. Second, money laundering schemes using banks are relatively well-known and a risk-based business approach has proved efficient both for banks and their supervisor in the prevention and detection of money laundering. On the contrary, and despite many typology exercises, (conducted *inter alia* by the FATF) the level of detection and of reporting of suspicious transactions in the non-banking financial sector remains very low (cf. statistics on STRs in Part 3).

- ***Situation of Legal Persons Within Cyprus***

Companies in various forms are the most common type of legal person in Cyprus. The country's low corporate tax rate has attracted international business for more than two decades and the country has a strong tradition of company law. Cyprus' accession to the EU has driven the country to harmonize its company law with relevant EC Directives, driving changes towards more transparency, a general upgrade in accounting standards, and the stronger protection of creditors, investors, shareholders and third parties.

Offshore Activity and International Business Enterprises

In 2002, legislation put an end to Cyprus' "offshore" regime, which was creating tax advantages for International Business Enterprises ("IBEs," previously known as "offshore companies"). Both the prohibition from doing business locally and the fiscal distinction between local and international companies have been abolished. A transition period giving preferential tax treatment to IBEs that existed prior to 2002 expired on January 1, 2006. All companies are now subject to a single legal and tax regime at a uniform rate of 10%, irrespective of the company ownership and places of operation. The 10% tax rate remains very attractive compared to current corporate tax rates in countries across the EU. Since Cyprus joined the EU, the country has developed into a popular base from which international investors and multinational companies plan, hold and manage their trans-border investments through Cyprus-registered holding companies.

[5] Committee of Experts on the Evaluation of Anti-Money Laundering Measure (MONEYVAL), Third Round Detailed Assessment Report on Cyprus, Feb. 2006. Paragraph 57.

Cyprus law provides for companies limited by shares (divided into public and private companies) and companies limited by guarantee[6]. A company is established by incorporation at the Department of Registrar of Companies and Official Receiver ("DRCOR"), and paperwork is submitted by a lawyer practicing in Cyprus who drafts and signs the Memorandum and Articles of the company. The register must contain *inter alia* the registered office address, the names of the current directors, shareholders and secretary and a report on the allocation of shares. Overseas companies (incorporated abroad) can establish a place of business in Cyprus simply by registering with the DRCOR. The majority of customers establishing Cyprus-registered companies appear to be based outside the country, thus creating a serious challenge to confirming customer information.

Though the offshore regime has been abolished, a number of suspicious entities controlled by non-residents could clearly continue to operate. It is unclear whether the beneficial owners of the more than 50,000 IBEs formally registered in the offshore sector are now known to the Cyprus authorities[7]. The large number of offshore companies in the form of "brass plates" (i.e. they have no physical presence in Cyprus) raises concerns with respect to monitoring their activities and their vulnerability to money laundering. More than 54,000 offshore companies have been registered from 1975 to date, most of which have no physical presence. Cyprus authorities claim that tax reform pursuant to EU accession will reduce the country's vulnerability to money laundering activities as it will enable better monitoring of the sector. To this effect, bearer shares have also been abolished.

Company Services Providers

As a result of enhanced surveillance by international organizations and European authorities in Cyprus, money laundering is more likely to take place at the layering stage through other, mostly non-cash and non-bank financial transactions. The majority of suspicious transaction reports originate from the banks, and seldom from lawyers and accountants. This raises a red flag since both lawyers and accountants are active in setting up IBEs and trusts.

Further control of the IBE sector has been targeted by requiring the lawyers creating, operating or managing companies, or organizing the contributions necessary for the creation, operation or management of companies, to comply with AML provisions. Cyprus' compliance can't be accurately gauged until the effective commitment of these company service providers (i.e. lawyers) to comply with AML requirements is ascertained.

On-site inspections of lawyers (comparable to un-notified inspections conducted by supervisory authorities of other subject entities) are not included in the requirements derived from the AML legislative and regulatory framework. The Cyprus Bar Association has indicated that they had no intention to conduct on-site inspections of law firms, thus demonstrating their perhaps blind trust in lawyers to fulfill AML duties.

So far, hardly any suspicious transaction reports have originated from lawyers and accountants. There are 1,631 registered practicing lawyers and 1,858 registered accountants in Cyprus and they play a critical role in the financial sector, so the low number of reports is alarming. Over the last two years, lawyers and accountants have only just started to issue reports on a small number of cases (see Part 3). Stagnation in the number of suspicious transactions reports would be highly suspicious.

Trusts

In July 1992[8], Cyprus enacted into law a bill providing for the formation and administration of offshore trusts. The 1992 bill built on existing law and modernized trusts legislation and offered considerable incentives for the establishment of trusts in Cyprus. In Cyprus, an international trust may be described as a trust created by a non-resident settler for the benefit of non-resident beneficiaries. The 1992 law defined an international trust as being a trust in respect to which (i) the settler is not a permanent resident of Cyprus (i.e. does not hold a Cypriote Passport); (ii) no beneficiary (other than a charity) is a permanent resident in Cyprus; (iii) the trust property does not include any real property situated in

[6] For detailed information on companies in Cyprus, see http://www.lawandtax-news.com/html/cyprus/jcylatcos.html#company

[7] International Narcotics Control Strategy Report 2007, country report on Cyprus.

[8] Law No. 69/92 also known as "International Trusts Law"

Cyprus and; (iv) at all times there is at least one trustee resident in Cyprus. Moreover, according to the law, a trust will still qualify as an international trust even if the settler, the local trustee, or a beneficiary (or any combination of those) is a Cyprus offshore company or partnership.

International trusts law guarantees confidentiality and privacy of the constitution of international trusts and their transactions, and prohibits any of trustees or other persons, including government officials and officers of the Central Bank, from disclosing any information regarding the trust. However, a court, before whom criminal or civil proceedings could be pending, may order the disclosure of documents or information relating to an international trust, provided such a disclosure is crucially relevant for the outcome of the pending proceedings. In other words, investigation in relation to money laundering could override trust secrecy provisions. Using a trust to conceal illegally gained assets would in all likelihood constitute an offense under the 1996 AML law. However, although theoretical access to information overrides trusts secrecy provisions in the case of a money laundering investigation, practical screening of existing trusts, some of them established a long time ago, is challenging.

Trust and company service providers are not yet required to apply customer identification, record keeping, internal reporting and other AML procedures. Guidance Notes have been issued to International Trust Companies by the Central Bank of Cyprus in January 2005 but when an assessment team from the Council of Europe's Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures ("MONEYVAL") visited Cyprus in April 2005, the notes had not been issued to most trust and company service providers. The Cyprus authorities have drafted legislation that will provide for the licensing and regulation of trust and company service providers (in line with the requirements of the Third EU Directive). Draft legislation is currently being discussed among financial services professionals and government officials and is expected to come into force in the second half of 2007.

Weak Oversight of Legal Persons

Cyprus is clearly vulnerable to the abuse of legal entities for money laundering purposes. This vulnerability is in fact the main weakness in the current AML regime. First, lawyers forming and administering companies are subject to AML law but, as mentioned above, they seem to rarely report suspicious activity. Not all institutions (including company service providers) are required to verify beneficial owners and control information by law and guidance. In particular, the AML law does not explicitly cover trust service providers. Second, the size of Cyprus' companies and trusts industry raises issues about screening and monitoring capacities. Performing due diligence is all the more difficult as most customers are non-residents. Moreover, checking the thousands of existing IBEs registered over time in the DRCOR is a huge task: due diligence requires availability of information and colossal human and financial resources. It is one thing to ensure that AML requirements are practically implemented, and another to actually verify the quality of what has been done over the past decades and then to search, if applicable, for missing information.

- ***Criminal Environment in Cyprus***

Greek Cyprus has a relatively low rate of domestic crime and a good percentage of solved cases (constantly exceeding 70% over the last several years).

The authorities in Cyprus believe that there is no major threat posed by domestic organized crime as organized criminal activities do not exist in large scale and their social and economic impact is limited. Authorities insist that for the last ten years, only a few murders can be directly related to organized crime, and that the activities of the two small organized crime groups operating in Cyprus are restricted to domestic operations with no link or cooperation with any other illegal organized groups based overseas. This belief is consistent with the fact that money laundering cases prosecuted so far appear to be dealing with the domestic proceeds of organized crime.

According to Europol, the operating structures of present domestic crime groups with a local presence are based mainly on kinship and common interest in gaining profits. The predominant nationalities are Greek-Georgian and Greek-Russian, and these groups are primarily involved in the distribution of

narcotic substances, burglaries, thefts from cars, extortion and robberies[9]. The Cypriote authorities deny any tradition of narcotic production or trafficking and claim that local use of narcotics is limited. However, the US Department of State considers that "fraud and other financial crimes, and narcotics trafficking are the major sources of illicit proceeds laundered in Cyprus[10]".

The risk of the island being used by transnational organized crime groups should not be overlooked by Cypriote authorities. Europol recently reported that Cyprus is being used as a stepping stone for illegal immigration to other European countries. Illegal trafficking in human beings is reputed to be run by organized crime groups from abroad. Likewise, according to the US CIA, Cyprus is a primary destination for a large number of women trafficked from Eastern and Central Europe, the Philippines, and the Dominican Republic for the purpose of sexual exploitation. This might indicate that Cyprus' authorities are underestimating the activities of organized crime on the island. By overlooking this relatively well-known criminal activity, authorities run the risk of also overlooking the financial side of these activities that generate proceeds likely to be laundered locally.

Like their reluctance to admit their issues with international organized crime, Cyprus' authorities have always been reluctant to admit that they had a problem with money laundering. When there was a strict control regime in place, the Cypriote authorities considered that the possibility of money laundering at a placement stage was minimal. As the case studies below clearly indicate, this risk was underestimated.

The following Case Studies point out the Cypriote element in high profile money laundering and other serious crimes of the 1990s and early 2000s.

Case Study 1: RJR Nabisco

This case involved the US cigarette manufacturers RJR Nabisco, RJ Reynolds and Philip Morris[11]. In 2000, the European Union filed a lawsuit[12] in US Federal District Court against RJR Nabisco alleging global money laundering by the corporation for various mafia and organized crime groups. Allegedly, RJR knowingly sold their products to organized crime around the world (including Italian organized crime, Russian organized crime through the Bank of New York), arranged for secret payments from organized crime, and laundered such proceeds in the United States or offshore venues known for bank secrecy, including Cyprus. Specifically, **Cyprus was elected to launder criminal proceeds through cigarette sales.**

According to the trial's transcripts, in May 1997, RJR received a letter from one of its primary agents for the storage and handling of cigarettes in the European Community, notifying the company that a substantial number of RJR's customers were "involved in major EC-fraud" and therefore likely to pay RJR with criminal proceeds. In response, RJR redirected their supply of cigarettes to these customers through **Cyprus.**

RJR also **violated the Iraqi embargo by smuggling cigarettes into Iraq through Cyprus-based front companies.** According to a separate Plaintiff's memorandum[13] of law in support of motion to submit a proffer of evidence concerning the link between cigarette smuggling and terrorism, RJR provided consignment of Winston branded cigarettes to Cypriote companies for years. Part of the scheme was to falsely declare that the shipments were destined for export (i.e. to Russia) when, in fact, the products were destined for countries outside Cyprus and Russia, including Iraq.

Case Study 2: Oil-for-Food Program

Another ongoing investigation relates to the implication of Benon Sevan, a Cyprus citizen, in corruption relating to the Iraq Oil-for-Food Program. A UN-established inquiry into the US$ 64 billion

[9] 2004 European Union Organised Crime Report, Europol, Dec. 04, Country Profile on Cyprus.
[10] INCSR 2007. Country report on Cyprus.
[11] RJR Nabisco, Inc., was an American conglomerate formed in 1985 by the merger of Nabisco Brands and R.J. Reynolds Tobacco Company. RJR Nabisco was purchased in 1988 by Kohlberg Kravis Roberts & Co. in the largest leveraged buyout in history. In 1999, due to concerns about tobacco lawsuit liabilities, the tobacco business was spun off into a separate company, and RJR Nabisco was renamed Nabisco Holdings Corporation.
[12] See transcripts on http://www.ash.org.uk/html/smuggling/rico/eurjrfiling.pdf
[13] See transcripts on http://w.zww.ash.org.uk/html/smuggling/rico/euterrorism.pdf

program investigated allegations that Sevan received cash kickbacks for steering lucrative Iraqi oil contracts to an Egyptian oil trader at African Middle East Petroleum.

The Independent Inquiry Committee, headed by Paul Volcker, the former chairman of the US Federal Reserve Board, said the inquiry had discovered **bank accounts of Sevan's** in Switzerland and **Cyprus**. The report disclosed that Sevan received US$ 160,000 during the program's operation, which he said came from an aunt in Cyprus. The report concluded that the aunt did not have access to that amount of money. Sevan has denied wrongdoing and has returned to his native Cyprus.

In January 2007, Sevan was indicted in New York on charges of bribery and corruption. But Cyprus does not have an **extradition** treaty with the United States covering financial crimes. In the absence of an extradition treaty, citizens from either country cannot be extradited without the approval of the Attorney General of that country. Diplomatic relationships between the US and Cyprus are reported recently "strained over Sevan's extradition[14]".

Case Study 3: Milosevic

In 2002, a report by Morten Torkildsen, an investigator at the United Nations war crime prosecutor's office, accused **Popular Bank (Laiki)**, the second largest bank in **Cyprus**, of **having facilitated financial transactions from Belgrade to the benefit of Milosevic in defiance of UN sanctions** imposed in July 1992. Allegedly, a group of **Yugoslav-controlled Cyprus-registered front companies** were instrumental in supplying Milosevic's government with fuel, weapons, raw materials and other goods to pursue war in Bosnia (1992-1996) and in Kosovo (1998-1999).

Greek Cypriotes overwhelmingly backed the Milosevic regime during the wars. Allegedly, the number of Yugoslav-controlled front companies based in Cyprus soared to more than 7,000 in the early 1990s, when the war raged in the Balkans. The companies were registered as offshore trading businesses and financed with **cash flown from Belgrade to Cyprus**. The number and amount of transfers purportedly increased after the UN re-imposed an arms embargo in March 1998, pursuant to the worsening of the conflict in Kosovo.

According to the *Financial Times*[15], "Dragomir Stojkovic, a courier with the National Bank of Yugoslavia, flew to Cyprus on a private aircraft almost every week between March 1998 and March 1999. The cash he accompanied was stuffed into reinforced paper sacks used for packaging cement and handed over to Popular Bank officials at Larnaca airport. Mr. Stojkovic declared a total of DM 453 million [approximately US$ 308 million] to customs officials at Larnaca airport, filling out the forms required under banking regulations on cash imports. The entire amount was deposited in a D-Mark account at Popular Bank belonging to Browncourt Enterprises, one of the Cyprus-based front companies. The Central Bank gave special approval for the money brought by Mr. Stojkovic to enter Cyprus, because the amounts exceeded the US$ 100,000 ceiling then permitted for a single cash transfer. Browncourt Enterprises and another seven front companies were registered as Cyprus-based offshore companies by the law office headed by Mr. Papadopoulos, legal adviser both to Popular Bank and Beogradska Banka".

Interestingly, these transactions took place before *and* after the anti-money laundering legislation was adopted in 1996 and Cyprus started EU accession talks in 1998. A likely explanation for this is the combination of the political support of Milosevic's regime, and lax enforcement of money laundering legislation in the 1990s (peer pressure policy developed by the FATF resulted in the first "black list" of Non-Cooperative Countries and Territories being published in 2000 and international focus on money laundering expanded worldwide after 9-11). Interestingly, recent reports in Greek Cypriote newspapers aggressively discuss the business relationship maintained in the 1990s by the late Milosevic and the President of Cyprus Tassos Papadopoulos, a former lawyer (quoted in the *Financial Times* article) who took office on March 1, 2003. Several Serbian-owned Cyprus-registered companies mentioned in the UN report had been registered by the law firm of Tassos Papadopoulos in the 1990s. Cyprus' cooperation in the international probe relating

[14] Financial Mirror, Cyprus-Us ties strained over Sevan extradition, February 16, 2007.
[15] Financial Times, Defiant Greek-Cypriote Bank Helped Fund Two Wars, Kerin Hope and Stefan Wagstyl, July 25, 2002.

to the Milosevic case is suspected to be hampered by those formerly close ties between the two men. Cyprus officials are denying those allegations.

Criminal Links to Russia

Historically, Cyprus has had the reputation of being the place where the Russian mob laundered illegally gained money.

In the early transition years after the collapse of the Soviet Union, the magnitude of capital flight from the Russian Federation was significant. This was acknowledged by many sources, although there is no consensus about its nature (legal vs. illegal proceeds) and size. According to a study released by the UN, "the amount of capital flight from the Russian Federation which is likely to be related to money-laundering is estimated at US$ 133 billion during the period 1992-1997. This estimate is a symptom of significant underlying factors. Two inherent features of contemporary capitalism in the Russian Federation— crime and the "shadow" economy—could be linked to the bulk of illicit proceeds which require laundering for safekeeping or further investment[16]". International experts estimated that up to US$ 1 billion flowed from Russia to Cyprus each month and that the money then worked its way from there to Western Europe and the United States as investment capital[17]. Cyprus' close relations with Moscow under communism, the absence of anti-money laundering legislation and a treaty on the avoidance of double taxation, together triggered this flood of "suitcase" money. Interestingly, money flow is now coming from Cyprus into the Russian economy: in 2006, Cyprus accounted for 22.6% of foreign investments in Russia, followed by the Netherlands (16.4%) and Luxembourg (16%). It is very likely that a portion of this money comes from previously flown capital harboured and laundered in the island and elsewhere.

The Russians in Cyprus became a subject of legend in the 1990s, with stories of villas costing millions of dollars bought with cash and without bargaining. During this time, Cyprus registered 2,000 Russian companies, including branches of many banks like Inkombank, Menatep, Agrostroiprombank, Avtovazbank and others. In 1995, after Cypriote visas were no longer required for Russian citizens (visa requirements were reintroduced in 2003), this process accelerated considerably. In 1996, the number of Russian companies operating in Cyprus was reported to have reached 16,000.

An offshore company in Cyprus used to be the default option for Russians keen to avoid taxes and to protect "their share" of an estimated US$ 200 billion spirited out of Russia since the collapse of the Soviet Union in 1991. A popular scheme was to use Cyprus-registered shell companies to buy state assets at below market prices and then siphon off hard currency profits. A number of scandals that blew up in the late 1990s provided real evidence that Cyprus was effectively used in international money laundering and capital flight schemes.

Case Study 4: Bank of New York

The money laundering scandal involving the Bank of New York ("BONY"), the oldest bank in the United States, began in 1996. In late 2005, BONY settled with US federal regulators for US$ 38 million. Meanwhile, BONY's role in a huge money laundering operation operated by Russian organized crime had made the headlines. The illegal operation involved Russian expatriates - one who was a Vice President of the bank - moving over US$ 7 billion via hundreds of wires to launder illegal proceeds. This case is multifaceted and we will mention here just one of the schemes involving Cyprus.

The Bank of New York was, since 1992, the prime correspondent bank of virtually all Russian banks. It acted as the primary western correspondent bank for Inkombank, a Russian Bank which collapsed in 1998, as a result of systematic looting of bank assets by its principals (see Case Study 5). Through this correspondent banking relationship, BONY provided Inkombank with unrestricted access to the western banking system, thereby knowingly facilitating money-laundering, multi-billion dollar conversion of assets and capital flight. BONY personnel allegedly participated in the formulation of schemes which aimed at looting the Inkombank assets through sham stock transactions. One of them involved a **Cyprus-registered shell company, Aspirations Holdings Ltd.**

[16] Russian Capitalism and Money Laundering, Global Programme Against Money Laundering, UNODCCP, 2001.
[17] Source: Frankfurter Allmemeine Zeitung, The Rich History of a Haven in the Sea, May 9, 2006.

Allegedly, Aspirations Holdings, Ltd. purchased 1,200 common registered shares of Inkombank with a face value of 1,200,000 Russian rubles. At that time, the existing rate of exchange was 200 Russian rubles to 1 US dollar. Thus, the purchase price actually paid by Aspirations was US$ 24,000. Aspirations and Inkombank then entered into an agreement whereby Inkombank would buy back its shares for US$ 2.4 million, or one hundred times the amount paid by Aspirations. The 1996 audit of Inkombank by the Central Bank of Russia showed that the "agreement" had no "requisites" of Aspirations (i.e. the address, etc.), and the signature of the purported "foreign shareholder" (Aspirations) was illegible. Nonetheless, Inkombank was through this sham transaction, able to embezzle close to US$ 2,4 million of bank assets, by funnelling funds through BONY's accounts with BONY's advance knowledge that the transaction was bogus[18].

Case Study 5: Inkombank

Set up in 1988, Inkombank was once one of Russia's largest banks, whose billboards proudly announced its motto "We are for real, we are here to stay". In 1996, the Central Bank of Russia had conducted an audit of Inkombank and issued a highly critical report. Two years later, in October 1998, the Central Bank of Russia revoked Inkombank's license to conduct banking business and Inkombank was subsequently ordered to be liquidated.

Inkombank had a very active **branch in Cyprus,** which opened in 1993 and developed an intense retail banking business. In November 1998, and pursuant to the Central Bank of Russia's action toward the bank, the Central Bank of Cyprus revoked the license of Inkombank's Limassol-based international banking unit.

A link has been established between Inkombank and Semion Mogilevich[19] ("Wanted" by the FBI for "Racketeering, Securities Fraud, Wire Fraud, Mail Fraud and Money Laundering" [20]). According to intelligence sources, because of its rapid expansion, Inkombank was short on liquidity in the mid-1990s and Mogilevich offered to "help". A secret deal was struck between Inkombank's then chairman, Vladimir Vinogradov and Mogilevich's representatives, whereby in exchange for US$ 65 million, and a promise to help gain Inkombank's entree into the world's arms market which Vinogradov desperately sought, Mogilevich's front entities were given 23% in Inkombank's equity, gaining *de facto* control of the bank.

Allegedly, the **Cyprus-based branch of Inkombank was used to channel funds from Russia to take part into secretive business deals**. In 1996, Mogilevich allegedly used his connections to help Inkombank win a bid for 25% of the common stock of Sukhoy, a manufacturer of the Russian SU fighter jets. Sukhoy is reported to have generated US$ 1 billion in sales in the three-year period after Inkombank became its largest shareholder. Purportedly, the proceeds were largely funneled from the **Inkombank-Cyprus** branch through BONY correspondent accounts to various offshore firms, including Brasset, Footnote and Bridge Investments, controlled by Vinogradov and Mogilevich.

Case Study 6: Menatep-Cyprus

Bank Menatep was a US$ 29 billion holding company created by Mikhail Khodorkovsky (now jailed in Russia for money laundering). It had indirect controlling interest in Yukos Oil Company (see Case Study 7) and was involved in the US$ 4.8 billion diversion of International Monetary Fund funds. The bank's financial condition was seriously damaged during the 1998 financial crisis due to risky investments. The Russian Central Bank revoked Menatep's license in May 1999. The bankruptcy was finalized by February 2001. Between August 1998 and May 1999, the bank's assets were siphoned off by the owners and management, effectively defrauding creditors. Over 15,000 people lost their savings. Menatep had an **operation in Cyprus**.

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[18] Source: Lawsuit of the depositors of the Russian Bank Inkombank against the Bank of New York, Southern District of New York. 15 November 1999.

[19] According to the Moscow telegraph, Mogilevich is one of the most powerful godfathers in the world, running an organized criminal organization involved in narcotics, weapon trafficking, prostitution, money laundering and other financial crimes, gambling, and spanning over Russia, Hungary, Ukraine, Belorussia, Lithuania, Israel, United States, Columbia, Pakistan, Lebanon, Germany, Austria and dozens of other countries. For detailed biography, see http://www.moscowtelegraph.com/mogilevich.htm

[20] See link http://www.fbi.gov/wanted/alert/mogilevich_s.htm

Cyprus-based Menatep bank branch was used for high-stakes, low-profile transactions. For instance, one deal allegedly involved the titanium giant VSMPO-Avisma. Between 1994 and 1998, senior Yukos managers including Khodorkovsky owned - via Menatep - more than 60% of Avisma, which was later merged with VSMPO. In 1998, Menatep sold its stake of US$ 80 million to a group of foreign investors who started to scrutinize Avisma trading arrangements. A series of international lawsuits filed in early 1999 contain allegations that Menatep had been diverting tens of millions of dollars from Avisma into its own pockets and continued to do so even after selling the stake. Menatep was purportedly using transfer-pricing schemes to sell Avisma's titanium at a knockdown price to an Isle of Man-based trading company, TMC Holding, and was keeping the money offshore. According to the Moscow Times, in one transaction, Menatep-linked directors at TMC transferred nearly US$ 10 million to **Menatep-Cyprus** several months after the bank went under in the 1998 financial crisis, according to the lawsuit. Menatep denied any wrongdoing and standoff was eventually settled out of court.

Case Study 7: Yukos and Khodorkovsky

Yukos Oil was created in 1993. Its assets were acquired under controversial circumstances from the Russian government during the privatization process of the early 1990s. Until 2006, Yukos was of the world's largest non-state oil companies, producing 20% of Russian oil—about 2% of world production. The company was controlled by Russian billionaire Mikhail Khodorkovsky and a number of prominent Russian businessmen via the offshore holding company Menatep. The corporate structure of Khodorkovsky's empire was very intricate and, for the part of it which was known, built on companies registered in offshore centers, including Cyprus. Group Menatep Ltd. based in Gibraltar, owns 100% of Yukos Universal Ltd., based in the Isle of Man, which in turns owns 100% of **Hulley Enterprises Ltd., a Cyprus registered company**. Hulley is the official holder of 1.29 billion shares of Yukos, or 57.5% of its total. Yukos Universal holds another 3.5%. The value of the combined stake thus sheltered is US$ 15.8 billion.

In July 2004, Yukos was charged with tax evasion, for an amount of over US$ 7 billion. The Russian government accused the company of misusing tax havens inside Russia in the 1990s to reduce its tax burden. Additionally, Khodorkovsky is charged with creating an organized group of individuals with the intention of taking control of the shares in Russian companies during the privatization process. On August 1, 2006, a Russian court declared Yukos bankrupt. Khodorkovsky was imprisoned and sent to Siberia; some other former top executives have fled Russia.

Russian prosecutors are investigating several aspects of this case. One aspect under investigation is illegal action in the privatization process of the former state-owned mining and fertilizer company Apatit. It is alleged that four companies that participated in the privatization tender for 20% of Apatit's stock in 1994 were shell companies controlled by Khodorkovsky and Lebedev (a very large shareholder in Yukos arrested and charged in July 2003), registered to create an illusion of competitive bidding that was required by the law. One of the shell companies that won that tender (AOZT Volna) was supposed to invest about US$ 280 million in Apatit during the next year, according to their winning bid. According to the prosecution, the investment wasn't made and Apatit sued to return their 20% of stock. At this point, Khodorkovsky had transferred the required sum into Apatit's account at Menatep Bank and sent the financial documents to the court, so Apatit's lawsuit was thrown out. The very next day the money was transferred back from Apatit's account to Volna's account. After that the stock was sold off by Volna in small installments to several smaller shell companies, which were, in turn, owned by more Khodorkovsky-owned companies in a complicated web of relationships. **For that purpose, dozens of companies were established in offshore places, including Cyprus.**

Cyprus comes up again in the Yukos case in respect to harboring a person wanted by the Russian authorities. In the summer of 2003, immediately after the arrest of Lebedev, businessman Vladislav Kartashov settled in **Cyprus**. Allegedly Khodorkovsky's accomplice, Kartashov led three front companies that were used by Yukos to evade taxes. Kartashov is wanted by the Russian Prosecutor General's Office in connection with the Yukos case on charges of embezzlement as part of an organized group alleged headed by Lebedev and Khodorkovsky. Kartashov was arrested in Cyprus after a request from Russia was received by the Cypriote prosecutor in 2005, but he was released the following day after paying about US$ 70,000 in bail. The Russian prosecution promised to send new accusations of Kartashov's involvement in money laundering to Cyprus, including evidence derived

from another closely related embezzlement case. The disappearance of one major indicted player of this second case has delayed sentencing in the case in Moscow indefinitely and the Cypriote prosecutor has not officially received any more documents relating to Kartashov. According to Russian newspaper *Kommersant*, "Elena Loizidou, representing the **Cypriote prosecutor**, asked for a month-long delay in the case, in hopes of receiving official documents in the meantime. Loizidou told the court that "we have already received the documents unofficially. It follows from them that there is not only a political element in the case as the defense claims, but other aspects as well that need to be studied. The court agreed to delay the hearing for a month, but returned Kartashov's bail money to him.[21]" The Yukos case is ongoing.

Today, money laundering cases linked to Cyprus continue to make international news, however the details of many ongoing investigations are not publicly available. The small bits of information that are leaked to the press however confirm that the island remains a key player in a number of current money laundering cases and investigations. Financial crime continues to be an issue, and the presence of illegal money in the Cypriote financial sector, especially from Russian firms and criminal groups, seems to be an ongoing problem for AML supervisors and oversight bodies.

2. The Legal and Regulatory Framework to Prevent, Detect and Punish Money Laundering

- ***Review of Legislation and Recent Changes Derived from Accession to the EU***

Cyprus has put in place a comprehensive AML legal framework that complies with evolving international standards. Legislative amendments, practical measures and revision of the Directives issued by the Supervisory Authorities (i.e. the Central Bank, SEC, etc.) are currently underway to reflect new requirements derived from the Third EU Directive. The draft legislation is expected to be enacted and come into force in the second half of 2007.

Money laundering of funds from illegal drugs was criminalized in 1992, upon enactment of the Confiscation of Proceeds from Trafficking of Narcotics Drugs and Psychotropic Substances Law of 1992. Later, in 1996, Cyprus passed the Prevention and Suppression of Money Laundering Activities Law[22] and repealed the 1992 law. The 1996 law took a more comprehensive approach and criminalized both drug and non-drug-related money laundering, provided for the confiscation of proceeds from serious crimes, codified actions that banks and non-bank financial institutions must take (including customer identification), and mandated the establishment of a Financial Intelligence Unit, the Unit for Combating Money Laundering, also known as "MOKAS".

As of November 2000, the criminalisation of money laundering has been based on the very extensive "all crime approach". The scope of predicate offences covers all criminal offences which are subject to a sentence of more than one year's imprisonment. The offence of money laundering applies to any kind of property, either movable of immovable and wherever located, which has been generated by the commission of such predicate offence.

The money laundering offence applies to any person who knows or ought to have known that any kind of property constitutes the proceeds of crime, and nevertheless : (i) converts, transfers or removes such property, or (ii) conceals or disguises the true nature or location of such property, or (iii) acquires, possesses, or uses such property or (iv) assists in any of the preceding acts, or (v) provides false information to enable others to benefit from the commission of any predicate offence to money laundering. Hence, negligent money laundering is provided for, thereby exceeding what is required by international AML regimes.

[21] Kommersant, Khodorkovsky Accomplice Freed in Cyprus, 25 January 2007.
[22] The Prevention and Suppression of Money Laundering Activities Law, 1996-2004. (Law No. 61(I) of 1996, as amended with Laws No. 25(I) of 1997, 41(I) of 1998, 120(I) of 2000, 18(I) of 2003 and 185(I) of 2004).

In Cyprus, there is a mandatory obligation to report suspicious transactions relating to money laundering (without any financial threshold): all persons who reasonably suspect that someone is engaged in money laundering and who come across the information during their "trade, profession, business or employment" are obliged to report the money laundering offence to the police or to the MOKAS. All banks and non-bank financial institutions, insurance companies, the stock exchange, cooperative banks, lawyers, accountants, and other financial intermediaries must therefore report suspicious transactions to MOKAS. However, the law does not expressly provide for the reporting of attempted (uncompleted) transactions.

Amendments to Cyprus AML law passed in 2003 and 2004 implemented the EU's Second Money Laundering Directive. These amendments authorize the MOKAS to instruct banks to delay or prevent the execution of customers' payment orders; extend due diligence and reporting requirement beyond financial business to auditors, external accountants and tax advisors, real estate agents, dealers in precious stones and gems and, lawyers when they participate in a variety of professional activities (including the creation, operation or management of trust, companies or seminal entities); permit administrative fines of up to US$ 6,390; and increase bank due diligence obligations concerning suspicious transactions and customer identification requirements, subject to supervisory exceptions for specified financial institutions in countries with equivalent requirements.

The AML law authorizes criminal (but not civil) seizure and forfeiture of assets. Power to trace, freeze and confiscate direct and indirect proceeds and the associative investigative powers are provided for. The confiscation regime provided by the AML law refers to predicate offences (and not only to money laundering offences), even when they are prosecuted as stand-alone offences (i.e. without the occurrence of any demonstrable laundering activity). Confiscation applies equally to any property acquired as proceeds arising from the commission of a predicate offence. In order to make sure that criminal profits do not evaporate before confiscation can take place, the AML law also provides for interim orders – restraint orders or charging orders – enabling the freezing of property or proceeds.

In 2006, four money laundering cases (including two Foreign Restraint Court Orders registered and enforced by Cyprus courts upon an application made by the MOKAS) resulted in the freezing of approximately US$ 2.2 million in assets. Proceeds confiscated amounted to US$ 1.3 million (for a single case), which is very low.

Money laundering is punished with a sanction of up to fourteen years imprisonment if committed intentionally and, if otherwise punishable with up to five years of imprisonment. In both cases, a pecuniary penalty may be imposed in addition to a prison sentence or in place of it. Cyprus' weak AML sanction regime is discussed in detail in Part 3.

Cyprus is a party to the 1988 UN Drug Convention, the 2000 UN Convention against Transnational Organized Crime ("Palermo Convention") and the 1999 UN International Convention for the Suppression of the Financing of Terrorism. Cyprus is also a member MONEYVAL (the Council of Europe's Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures), as well as the Council's Offshore Group of Banking Supervisors (OGBS).

- ***The Due Diligence Regime***

A due diligence regime to address money laundering is in place and according to MONEYVAL, has been implemented "satisfactorily and efficiently[23]". Subject entities covered by the Cyprus AML law apply "know-your-customer" rules and comply with record keeping and internal procedures requirements. While banks generally have sophisticated guidelines and procedures, other financial institutions' regimes comprise only the basic requirements to identify the customer, closely monitor complex or unusual transactions and pay special attention to politically exposed persons.

Due Diligence: Subject Entities

[23] MONEYVAL assessment, Paragraph 3.

From 2001 to 2005, five sets of Guidance Notes ("GNs") were issued to financial institutions by various regulatory bodies: AML GNs to Banks, AML GNs to Money Transfer Businesses and AML GNs to International Financial Services Companies were all issued by the Central Bank. AML GNs to Brokers were issued by the SEC and AML GNs to life and non-life insurers operating outside Cyprus were issued by the ICCS. These GNs appear to be regularly updated. Moreover, in 2006, GNs prepared by the Cyprus Council of the Bar Association and the Council of the Institute of Certified Public Accountants have been circulated among these professionals, in compliance with the EC AML Directives. Cyprus' authorities have advised a MONEYVAL assessment team that "their firm view is that Guidance Notes issued by the various supervisory entities, under the AML law, constitute secondary legislation[24]" (i.e., are binding to the persons to which they are addressed and enforceable).

Cyprus is only "partially compliant" with the FATF Recommendation pertaining to customer due diligence provisions. A weakness in the Cyprus AML law lies in the possibility for most subject entities to identify customers without using independent source documents. For example, if an applicant is personally known to the person who examines the evidence, the examiner can be satisfied that the applicant is the person he claims to be[25]. GNs issued to accountants / auditors and others issued to lawyers require obligated persons to obtain "satisfactory evidence of identity" of those to whom they provide their services. The GNs provide that the individual's name and date of birth should be verified by requesting official documents bearing a photograph, and that the address should also be verified through bill checks, home visits, etc. The GNs also recommend that verification of identity with respect to legal entities should be made through a company search and/or other commercial enquiries. Practical implementation of such directives is very difficult to assess.

Another problem with Cyprus' due diligence regime is that there are no general rules to identify the beneficial owner except those provided in GNs for banks, insurance companies, stockbrokers and investment service providers. In addition, no customer due diligence measures are required in case of doubts regarding previously obtained customer data.

Cyprus' authorities indicate that these issues will be considered when amending AML legislation in the course of 2007. This is easier said than done. Many customer relationships were initiated when the AML requirements in Cyprus were less strict than they are today. Updating customer data is crucial to effective implementation of the AML regime, including going beyond possible straw men to identify beneficial owners of accounts and transactions. Redefining the rules governing relationships between a customer and a financial institution is all the more difficult when the relationship is long-standing: bankers commonly explain how they feel ill-at-ease harassing their long time customers with "red tape" concerns to comply with enhanced AML requirements.

Due Diligence: Banks

In recent years, the Central Bank has introduced many new regulations for banks aimed at strengthening AML vigilance in the banking sector, in line with the "Customer Due Diligence" guidelines established by the Basel Committee on Banking Supervision. In July 2002, the US Internal Revenue Service ("IRS") officially approved Cyprus' "know-your-customer" rules, thus enabling banks in Cyprus to acquire US securities on behalf of their customers[26]. Identification of the beneficial owner is especially targeted: among other requirements, banks must:

- Ascertain the identities of the natural persons who are the "principal/ultimate" beneficial owners of corporate or trust accounts;
- Obtain as quickly as possible identification data on the natural persons who are the "principal/ultimate" beneficial owners when there is a change in the customer profile (material change in the business name, officers, directors and trustees, or business activities of commercial account holders; or a material change in the customer relationship, such as establishment of new accounts or services or a change in the authorized signatories) or when a significant or unusual transaction occurs.
- Update these data on a regular basis (which implies checking existing customers).

[24] MONEYVAL, Paragraph 288.
[25] MONEYVAL, Paragraph 295.
[26] Source US Department of States, INSCR 2007.

The banks were also asked to pay special attention to business relationships and transactions involving persons from jurisdictions identified by the FATF as non-cooperative ("NCCTs"). As of October 2006, there are no countries listed on the FATF NCCT list.

- ***Regulation and Supervisions of Cash Transactions***

Since 1989, Cyprus Customs and Excise Department has exercised control over cash movements. However, its control appears weak as it did not prevent Milosevic's cash money from being flown into the country (see Case Study 3). The Customs and Excise Department has the legal power to interrogate persons and investigate offences under the Capital Movement Law of 2003 and the Suppression of Money Laundering Activities Law of 1996. A declaration system is in place thereby requiring arriving and departing passengers to declare to Customs any amount of banknotes either in Cyprus or in foreign currency, or the value of any gold equal to or in excess of 12,500 euros. Bearer negotiable instruments appear not to be covered by the Capital Movement Law. The declarations are checked by Customs agents, and if there is a suspicion that money laundering has been committed or could be committed, they are reported to MOKAS. In 2004, 880 imports declarations were filed whereas not a single export declaration was.

All banks must report to the Central Bank, on a monthly basis, individual cash deposits exceeding 10,000 Cypriote pounds (approximately US$ 22,000) or approximately US$ 10,000 in foreign currency. This prudential report must also contain the particulars of customers' cash deposits in foreign currency notes in excess of US$ 100,000 or the equivalent in another currency for which the Central Bank's prior written approval has been obtained. The banks have adjusted their computerized accounting systems as to be able to detect immediately all cash deposits in excess of these limits.

- ***Reporting of Suspicious Activity and the Financial Intelligence Unit ("MOKAS")***

The Cypriote Financial Intelligence Unit - Unit for Combating Money Laundering ("MOKAS") - was established by the 1996 AML law and became operational in January 1997. MOKAS receives and handles Suspicious Transaction Reports ("STRs") sent by subject entities and it is responsible for the classification, evaluation and analysis of information relevant to money laundering offences, for conducting investigations into such offences, and for issuing directives for the better exercise of its functions. In 2005, for the first time, MOKAS issued several warning notices, based on its own analysis, identifying possible trends in criminal financial activity. These notices have resulted in the closure of dormant bank accounts, thereby helping to clean up existing accounts within banks.

MOKAS also conducts AML training for Cypriote police officers, bankers, accountants, and other financial professionals. Training for bankers is conducted in conjunction with the Central Bank. Last, the Unit is engaged in awareness-raising initiatives involving both the public and the private sector, thus helping to establish a regular dialogue on money laundering related issues. MOKAS has put much effort into training, improving the quality of STRs and providing good feedback to banks. In 2006, the Council of Ministers in Cyprus designated MOKAS as the Supervisory Authority for real estate agents and for dealers in precious metal and stones. Consequently, MOKAS has met with representatives of these professions and is preparing a set of directives to be issued to these sectors to comply with the AML law requirements.

The MOKAS has access to financial, administrative and law enforcement information in order to analyze the STRs, including direct access to the Registrar of Companies database. Financial information can be obtained for investigative purposes using the provisions of the Criminal Information Law. Since members of the police are appointed as members of the Unit, MOKAS also has direct access to law enforcement information. All money laundering investigations are sent to the Unit by law. It is decided on a case-by-case basis which investigative body will work on the criminal investigation. The other major money laundering and financial crime investigative units come under the auspices of the Cyprus Police and include the Drug Law Enforcement Unit and the Financial Crime Unit (specialized in fraud and business crime). The investigators of the Criminal Investigation Department of the Police Headquarters can also investigate financial crimes and money laundering.

Since 2003[27], MOKAS has had the power to suspend financial transactions for an unspecified period of time as an administrative measure. MOKAS also has the power to apply for asset freezing or restraint orders affecting any kind of property at a very preliminary stage of an investigation.

MOKAS is a multidisciplinary unit. At the time of the MONEYVAL mutual evaluation report submission, in February 2006, MOKAS had a staff of fourteen, comprised of two lawyers, three accountants, four police officers, two customs officers and three administrative staff. In June 2006, MOKAS hired an additional six financial investigators. A representative of the Cyprus Attorney General's Office heads the Unit. All members are appointed by name, are on detachment from their administration of origin and have the status of investigator. All the information treated by the Unit is confidential and staff could be criminally liable in the case of a breach of secrecy. Reinforcing the MOKAS staff was a strong recommendation pursuant to the second evaluation carried out by MONEYVAL in 2002 and implemented by Cyprus' authorities. However, the number of new cases opened could indicate that more personnel are needed, and all the more that the MOKAS will have to endorse the role of the supervisor for real estate and precious metal dealers.

MOKAS maintains cooperation in international matters. A mutual legal assistance treaty between Cyprus and the United States entered into force on September 18, 2002. The Unit has been a member of the Egmont Group[28] since June 1998. It actively participates in the group and hosted the Egmont Plenary in 2006. MOKAS has signed memoranda of understanding ("MOUs") with seventeen foreign FIUs, though Cypriote law allows MOKAS to share information with other FIUs without an MOU.

Sustained efforts by the Central Bank and MOKAS to strengthen AML reporting have resulted in an increase in the number of STRs being filed from 25 in 2000 to 179 in 2006. However, most STRs come from banks despite Cyprus' diversity of financial and non-financial service providers. The second largest source of STRs is the Police. Detailed statistics regarding STRs and related cases are provided in Section 3.

- ***International AML Monitoring Groups' Assessments of Cyprus***

As previously stated, Cyprus underwent a MONEYVAL mutual evaluation in April 2005, the results of which were published in a report adopted at the MONEYVAL Plenary meeting in February 2006. The evaluation was entirely oriented on Cyprus' money laundering regime and based on the Financial Action Task Force ("FATF") 40 Recommendations + 9 Special Recommendations on Terrorist Financing ("40+9"), together with the European Directives 91/308/EEC and 2001/97/EC.The MONEYVAL report found Cyprus to be fully compliant ("C") in seventeen areas, largely compliant ("LC") in 22, and partially compliant ("PC") in ten of the FATF's 40 + 9 Recommendations. There were no criteria for which Cyprus was found to be noncompliant ("NC"). The good rating of "C" and "LC" and the absence of "NC" criteria is an indication that at least on paper, there are no major legal loopholes in Cyprus AML regime.

Having said that, Cyprus' rating performance in terms of assessing the AML regime and its implementation is in line with the ones of other financial centers, which have demonstrated willingness to set up an AML machinery compliant with international standards. Some of them have been compelled to change regulatory practices as a result of heavy international pressures (including being listed as non-cooperative). Cyprus, like other newly acceded EU countries, was driven to strengthen its AML regime by the prospect of joining the EU. It is disturbing that assessments of those financial centers with comprehensive AML legislation, including Cyprus, produce very comparable results: all these countries appear to have implemented AML standards in a robust and comprehensive way while at the same time, the incidence of money laundering on a global scale has not dropped. This may indicate serious flaws in the assessment criteria used to evaluate AML regimes and in particular, the

[27] Law 118 (I) of 2003.

[28] The Egmont Group of Financial Intelligence Units is an informal international gathering of financial intelligence units (FIUs). The Group was formed in 1995, and took its name from the palace in Brussels where the meeting took place. To be accepted in the Egmont Group, FIU have to comply with a number of high-standard requirements. Being part of the Group provides a framework to the exchange of information, together with access to the E.G training seminars.

focus on compliance with AML standards to the detriment of evaluation of oversight structures and detection of criminal practices.

In the case of Cyprus, one can wonder whether the reality of money laundering prevention and detection is as good as it looks. First, Cyprus authorities have rather consistently underestimated the island's issues with money laundering. Further, there is a discrepancy between the existing AML regime as it has been developed in the legal and regulatory framework, and the disappointing results in terms of cases successfully prosecuted, related convictions and confiscations. Moreover, Cyprus' historic links to Russian organized crime groups, as well as the repeated money laundering abuses committed during the 1990s, require further assessment of Cyprus vulnerability to criminal financial activity, including a case-by-case follow-up on "big" stories. Currently, the information available regarding the Cypriote law enforcement's side on those cases is scarce and incomplete.

Also related to the money laundering issue, Cyprus is undergoing rounds of assessments with respect to corruption: Cyprus is a member of the Group of States against Corruption ("GRECO") proceeding from the Council of Europe. The First Evaluation Round report on Cyprus was adopted in December 2001 by the GRECO Plenary, stating in its conclusions that "Cyprus appears to belong to the group of the more fortunate European countries that are not particularly affected by corruption[29]". But, the report also pointed out vulnerability factors that could alter the current situation. These have to do with (i) the relations of trust that inevitably develop in small societies (the Greek Cypriote population amounts to around 700,000) and (ii) the pressures on political office holders exerted by powerful social and financial groups.

Corruption offences are considered as predicate offences for the application of the money laundering legislation. Members of the police have received training on investigations dealing with acts of corruption and other forms of financial crime. Subject entities to the AML regime, notably members of the legal and accounting professions, have also been trained to identify and report on suspicious transactions, including corruption-related incidents. Cyprus was found to have "implemented satisfactorily" its training requirements as mandated by GRECO. The effectiveness of training should start showing in statistics relating to the reporting of suspicious transactions to MOKAS.

The Second Evaluation Round report on Cyprus was adopted in March 2006[30]. As for all countries subject to this second evaluation round, the report on Cyprus reviewed three different themes: (i) Proceeds of corruption, (ii) Public administration and corruption, and (iii) Legal persons and corruption. The report concluded that Cyprus had a comprehensive legal framework in the area of confiscation of proceeds from corruption. Regulations are derived primarily from the AML legislation as corruption offences are predicate offences for money laundering. Additionally, Cypriote AML legislation provides for civil and criminal liability of legal persons in corruption-related cases, including active bribery, trading in influence and money laundering. It is important to note however, that stipulated fines upon conviction for corruption appeared to be very low. The report advised Cyprus "strengthen the sanctions applicable to legal persons convicted of corruption offences with a view to making them more effective, proportionate and dissuasive[31]", thereby sending a stronger negative signal to the business community and would-be money launderers.

Both the first and second GRECO reports reviewed in detail the legal and regulatory framework in place to fight corruption. Though GRECO found these frameworks satisfactory, the assessments and reports did not address the enforcement side of Cyprus' AML legislation. Recommendations to enhance the effectiveness of law enforcement remained general: the Second Evaluation Round advocated for Cyprus to "enhance the specialization and training of the police with regard to the investigation of offences of corruption in general and the use of confiscation and interim measures in particular in order to provide for more proactive law enforcement[32]". Another recommendation suggested the improvement of general pro-activity in the fight against corruption. The reporting of incidents of corruption is the principal mechanism for triggering a criminal investigation. Improving detection and reporting is key to fighting corruption efficiently, which implies proactive intelligence

[29] GRECO, First Evaluation Round, Evaluation Report on Cyprus. Adopted by GRECO at its 7th Plenary Meeting 17-20 Dec. 2001. Paragraph 66.
[30] GRECO, Second Evaluation Round, Evaluation Report on Cyprus. Adopted by GRECO at its 27th Plenary Meeting 6-10 March 2006.
[31] Report Op. Cit. FN # 4. Paragraph 122.
[32] Report Op. Cit. FN # 4. Paragraph 38.

gathering and efficient information sharing mechanisms between the different administrations involved (in particular the Customs and Excise Department, the Income Tax and VAT Department, and the police).

3. Weaknesses and Loopholes in the Cypriote AML Regime

Cyprus' AML regime does not produce significant results if measured in terms of numbers of convictions and amounts of assets confiscated. Assessing the weaknesses in Cyprus' law enforcement is a very complex issue. Of related interest is the fact that Cyprus has a very protective regime for the individual: legal use of electronic surveillance, telephone tapping, etc. is very limited. The number of complaints against police officers is in general very low. Whether this results from massive blind public confidence in the police or, on the contrary, absolute lack of confidence in the system, has never been really tested.

Despite a comprehensive legislative and regulatory framework to prevent, detect and punish money laundering, MONEYVAL's detailed assessment of Cyprus has singled out some legal loopholes. The MONEYVAL report contained recommendations as to how Cyprus should improve its AML regime to be fully compliant with international requirements. Comments made by Cypriote authorities further to the assessment reflected their intention to take action to put into effect the assessors' advice. A progress report was submitted to MONEYVAL in February 2007[33]. The report provides information on improvements made in respect to the assessor's recommendations. Major changes to the current AML regime to fully comply with the international standards and the EU Third Directive should derive from the new legislation expected in the second half of 2007.

Loopholes Related to Beneficial Ownership

As it stands currently, identification of beneficial ownership of companies and trusts is insufficient. Loopholes relating to the identification of beneficial owners have already been mentioned in the discussion regarding the customer due diligence regime. As long as the identification of beneficial owners entering into a business relationship and in the course of such a relationship is not absolutely effective for all entities subject to AML legislation, Cyprus will continue to provide opportunities for money launderers. In order to bring its AML regime up to the international standard, Cyprus needs to require that financial institutions do the following:

- Verify the customer's identity using reliable and independent source documents,
- Verify that any person purporting to act on behalf of the customer is so authorized and check the identity of that person,
- Identify the beneficial owner (and verify his identity) and find out who controls legal persons and arrangements,
- Understand ownership and control structures,
- Apply customer due diligence to existing customers on the basis of materiality and risk.

A major issue with beneficial ownership is the situation of company service providers, who, for a long time, have not been required to obtain, verify and keep records relating to the beneficial ownership and control of legal persons. In 2006, Cyprus circulated GNs to Accountants/Auditors and Lawyers setting as a principal requirement the identification of beneficial owners as well as the persons who have ultimate control or significant influence over the business and assets of their clients. In the past, and unsurprisingly, the Cyprus SEC has had difficulty accessing information about the beneficial owner of shares registered in the names of lawyers that act as nominees on behalf of beneficial owners. The 2006 GNs do not yet fully comply with the Third EU Directive. Cyprus should therefore apply customer due diligence requirements to existing customers on the basis of materiality and risk and should conduct due diligence on such existing relationship at appropriate times[34].

Loopholes Related to the Control and Monitoring of Legal Persons

[33] MONEYVAL, Cyprus Progress Report 2007. Strasbourg, 21 February 2007.
[34] MONEYVAL . Recommended Action Plan to Improve the AML/CFT system.

Effective control of legal persons is in practice quite weak. The registration process is of a formal nature and no material checks are carried out to ensure of the correctness of the information submitted. According to the system of declaration to register a company, only an advocate practicing in Cyprus may certify that incorporation is legally correct. However, the Companies Law also permits "a person named in the articles as a director or a secretary of the company" to be accepted by the Registry.

In addition to insufficient due diligence on beneficial ownership, there are no legal measures to prevent a physical person convicted for an offence (including money laundering) committed through a legal person from carrying out further business through legal persons, or from acting in a leading position within a legal person. Therefore, legal persons could easily be used by money launderers to shield further criminal activity.

Another set of suggested improvements deals with record keeping requirements and the monitoring of transactions and relationships. In order to comply with international standards, records must be maintained for a minimum of five years: Cyprus should clarify its legislation and GNs to banks, brokers, international financial service companies and insurers so that it is clear records should be kept for at least five years following the termination of business relationships. Moreover, investment, insurance and international business sectors need guidance on enhanced vigilance requested in case of complex, important or unusual transactions or transactions that have no apparent economic or lawful purpose. For these transactions, the background and purpose of the transactions should be clarified.

Weak Sanctions regime

On the repression side, sanctions for money laundering and financial crimes are unsatisfactory and certainly not dissuasive enough to curb money laundering in Cyprus. According to international obligations agreed to by Cyprus, the whole policy of sanctions for persons failing to comply with the AML legislation should be made "effective, proportionate and dissuasive". Cyprus' sanctions for money laundering are not.

Currently, the AML Law stipulates that any person who allegedly fails to comply with the legislation is subject to an administrative fine of up to 3,000 Cypriote Pounds (approximately US$ 6,900) imposed by the competent supervisory authority, which is a small price to pay and does not de-incentivize money laundering and financial crime. In other words, a financial institution in Cyprus could fail on its customer due diligence duties, fail to report on suspicious transactions, etc., and pay only a modest fine. For persons not subject to a supervisory authority, the penalty is potentially higher: a fine of up to 3,000 pounds and imprisonment of two years. MONEYVAL assessors were told that none of the supervisory authorities (Central Bank, SEC and ICCS) has ever imposed a sanction as a result of infringement of AML procedures. MONEYVAL assessors also found that on-site inspections had not been conducted in all financial institutions and that where on-site inspections had been conducted, the Central Bank had never fined institutions for failure to comply with the legislation. Instead, letters containing recommendations for corrective action were sent, thus revealing weak oversight and sanctions policy.

Similarly, sanctions also appear to be weak for legal persons. Legal persons are subject to fines upon conviction for corruption offences (maximum 10,000 Cypriote Pounds or approximately US$ 23,000) and money laundering (maximum 2,000 Cypriote Pounds or approximately US$ 4,600). In theory, legal persons may be subject to exclusion from public procurement or other types of commercial activities and subject to a judicial wind-up decision. Winding-up (liquidating) a company is an extreme measure and it appears that it has never been applied, even in the case of criminal proceedings against a legal person.

In the same way, the law enforcement's attitude towards negligent money laundering seems rather lenient. In 2001, there were only two investigations for negligent money laundering and they did not result in prosecutions. No prosecutions targeting lawyers for money laundering offences have been made to date.

This lax sanctions regime sends a negative signal to entities subject to AML legislation and does not de-incentivize financial crime.

Confidentiality Issues

Another flaw in Cyprus' AML regime is the confidentiality required to deal with ongoing AML investigations. MONEYVAL noted that there were many exceptions to the "tipping off" offence (i.e. making a disclosure which may impede or prejudice the interrogation and investigation carried out in respect of money laundering). Instead of prohibiting the disclosure of the fact that an STR (or related information) is being reported to MOKAS, the formulation contained in Cypriote legislation requires knowledge or suspicion that a disclosure will obstruct an investigation under way. This is very difficult to prove and considerably limits the range and effectiveness of the investigation and/or prosecution.

Restrictions in the Legal Framework for Confiscation

Cyprus has an operational confiscation regime but it is effective only in the case of criminal proceedings. The legal basis for confiscation is contained in the Prevention and Suppression of Money Laundering Activities Law. According to this regime, confiscation is conviction-based and Cyprus authorities lack the ability to use civil forfeiture when there is no criminal conviction.

Poor Performance of the STR Reporting System

Statistics maintained by MOKAS are insufficiently detailed. A MONEYVAL assessment team advised MOKAS to keep more complete information on the breakdown of STRs, including between domestic and offshore sectors, and to also indicate processing times. As far as international cooperation is concerned, MOKAS should make detailed statistics available on the number of requests it receives, including response times and whether requests were fulfilled.

A close review of available statistics relating to money laundering cases in Cyprus show that: (i) there are few cases successfully prosecuted compared to the size of Cyprus' financial sector and (ii) convictions obtained are based on domestic laundering and are relatively basic cases. Although the legal basis to enable successful investigations and prosecutions for money laundering is satisfactory, the effectiveness of the police and supervisory bodies that use it is low.

Quantitatively speaking, the number of suspicious transaction reports reflects an upward trend over years, but remains low (less than 200):

	2001	2002	2003	2004	2005	2006
Number of STRs	108	93	106	153	151	179

Source: MOKAS

Secondly, despite increased pressure on non-financial institutions to report suspicions of money laundering activity, most STRs continue to originate from banks, while other subject entities are under-represented among reporting sources:

	2004	2005	2006
Commercial Banks	109	114	147
Insurance Companies			1
Broker Companies		3	1
Securities' Registrar			
Lawyers	1	3	5
Accountants / Auditors		4	1
Company Service Providers			
Trusts			
Supervisory Authorities		2	3
Money Remittance	2	5	9
Police	29	13	7
Customs	2	3	
Others (Gvt, Dpts, Embassies, Individuals,	10	4	5

Publications)			
TOTAL	153	151	179

Source: MOKAS

Third, the ratio of STRs received to cases opened is 100% in the last two years. But, final results in terms of judicial proceedings are disappointing:

	2004	**2005**	**2006**
Number of STRs received by MOKAS	153	151	179
Number of cases opened by MOKAS	143	151	179
Number of indictments	19	6	12
Number of convictions	6	1	7

Source: MOKAS

	2004	**2005**	**2006**
Investigations			
Cases	325	379	409
Persons	404	415	456
Prosecutions			
Cases	19	6	12
Persons	19	6	12
Convictions (final)			
Cases	6	1	7
Persons	6	1	7
Proceeds confiscated (in Euros)			
Cases	4	1	1
Amount	2,026,667	5,605	1,329,791

Source: MONEYVAL Progress Report 2007

Qualitative analysis demonstrates the difficulty Cyprus is encountering when it comes to complex money laundering cases. There are ongoing investigations and collaborations with foreign law enforcement for international money laundering cases but details of these investigations are not publicly available.

Statistics released by Cypriote authorities revealed that from 2001 to 2005, although there were money laundering cases prosecuted based on foreign predicate offences, none were successfully concluded. Moreover, there have been no prosecutions or convictions for money laundering by third parties as an autonomous offence, whether for domestic of foreign predicates. In other words, money laundering cases appear to be still targeted on the relatively "easy" cases of self-laundering (i.e. laundering one's own proceeds) with domestic predicates. High-profile, high stakes, and complex cases often related to organized crime have not been effectively tackled.

One of the obstacles to money laundering prosecution by third parties could be an uncertainty about the levels of evidence required to establish the predicate criminality. A MONEYVAL report advised that Cyprus' clarify legislation to put beyond doubt that a conviction for money laundering can be achieved in the absence of a judicial finding of guilt for the underlying predicate criminality, and that the latter can be proved by inferences drawn from objective facts and circumstances. The report also suggested that it may be helpful for prosecutors and law enforcement to have a common understanding that a court may be satisfied that the laundered proceeds came from a general type of predicate offence and not necessarily from a particularized offence committed on a specific date[35].

4. Further Cases and Testimonies

[35] MONEYVAL, Paragraph 166.

Reliable information derived from open-sources relating to the money laundering situation in Cyprus is scarce. Most actual cases relate to ongoing investigations. Others involve foreign law enforcement and details about the cases are not made public until the cases are closed. Information leaked to the press sometimes relates to "old cases", that is to say cases that were underway before Cyprus worked hard to become a "model AML student" among the ten countries that joined the EU in 2004. The crimes covered in these cases were committed only shortly prior to EU accession, and after AML rules were strengthened post 9-11, and signify perhaps that the Cypriote government tackled the AML issue more in response to EU requirements and international pressure than out of strong political commitment to clean up the financial industry. This could explain a noticeable shortfall in the pro-activity of law enforcement to follow on "big" cases, if not a temptation to "let things slide" until they really have to be dealt with.

- **Cyprus, as a jurisdiction, appears in a number of on-going cases currently prosecuted in third countries.** The suspicion of money laundering arose in third countries, and Cyprus authorities seem to be working in a cooperative manner to deal with the cases. Whether suspicious activity in relation to these cases should also have been detected in Cyprus, and whether STRs relating to these cases have effectively been sent to MOKAS, is impossible to say.

Case Study 8: Laundering Schemes Between the United Kingdom and Offshore Centers, Including Cyprus

In the United Kingdom, a major money laundering operation, working under the guise of a property buying business, was dismantled due to an investigation by the National Crime Squad (now the Serious Organised Crime Agency). The case is detailed in the Proceeds of Crime Update, published by the UK Assets Recovery Agency ("ARA")[36]:

"Two South Yorkshire men used a complex system of off shore bank accounts, property acquisition and corrupt financial officials to launder around £200,000, believed to be the proceeds of cigarette smuggling. In July at Leeds Crown Court, both men and a third man pleaded guilty to money laundering offences between 2001 and 2004. One man was sentenced to 4 years, the other to 3 years 9 months and the third man to 1 year and 9 months. The third man from York was also given a confiscation order of £57,000 to be repaid within three months or he faces an extra two year prison sentence in default. The investigation uncovered that one of the men, an international cigarette smuggler, would give large sums of cash to the third man, a bookmaker. In return he would write cheques for a like amount to be paid into various bank accounts opened by others in Luxembourg. Cheques totalling around £100,000 were involved. The bookmaker would write fictitious names on the cheque stubs and claim these represented legitimate winnings by the cigarette smuggler whose business records did not support this. The money was banked in Luxembourg then transferred to a limited company on the Isle of Man set up by the second man. This company would buy property in Doncaster and Newcastle which this man bought back in his own name by making fraudulent mortgage applications. He would then transfer the equity in the Isle of Man to accounts held in Jersey and then to accounts held in Prague. **That money would then be transferred to an account held by the smuggler in Cyprus.** The money was then 'smurfed' - broken into small amounts and remitted electronically - back to his associates in the UK, where it was drawn out as cash and handed back to him. Financial hearings against the other two men will take place later in the year".

Other cases involving Cyprus are reported by the UK ARA:

"On 20th January 2005 at Laganside Crown Court, a Confiscation Order was made against one defendant for the sum of £500,000 and a second defendant for the sum of £201,163. An investigation which focused on a Bureau de Change located on the border between Northern Ireland and the Republic of Ireland found that cash being received by the bureau which was being held on 'account' using false names had emanated from criminal activities, e.g.: fuel, livestock and cigarette smuggling and drugs trafficking. The principal offenders also used the cover of the Bureau de Change to operate an elaborate VAT evasion fraud by showing 'paper' transactions in relation to the purchase and sales

[36] Issue N°28 13, 13 September 2006.

of Coca-Cola products. The VAT aspect of the operation generated funds which were then transferred worldwide on behalf of international criminal gangs with the value of the transaction being deducted from the clients account held at the Bureau. One suspect has already been convicted in the Republic of Ireland and sentenced to five years imprisonment for money laundering and operating as an illegal bank. He was ordered to pay back 2.5m Ir. This is the largest Criminal Confiscation amount to date in Northern Ireland and a major success for Police Service Northern Ireland Financial Investigation Unit. **This investigation also had an international aspect to it as the monies held on account at the Bureau were to be transferred to foreign jurisdictions.** In total 33 Letter of Requests have been completed and enquiries carried out in South Africa, Belgium, Holland, Switzerland, **Cyprus**, Germany, Malta, Denmark, Hong Kong, Jersey, Guernsey, Republic of Ireland and Isle of Man. Many investigations have commenced in these jurisdictions as a consequence of Operation Beaumont. The investigation also sought help from European Anti Fraud Office (OLAF) in Brussels and FIOD in Netherlands and those departments coordinated and assisted in many meetings and enquiries worldwide[37]".

In Scotland, the ARA has reported:

"On 21 November a Confiscation Order for £1.29 million, the highest in Scottish legal history was awarded. In October 2000 a man was arrested and charged by HM Revenue & Customs (HMRC) in respect of a £3 million VAT evasion and his assets were restrained under the Proceeds of Crime Act 1995. He was convicted in June 2004, sentenced to 4 years imprisonment and released from prison in July 2006. A parallel financial investigation identified assets totaling over £1.5 million, including a house worth £900,000. The house had been purchased in the name of an offshore company with funds from Greece. HMRC commenced a financial investigation working jointly with the Crown Office Financial Crime Unit involving enquiries with the authorities in Greece, **Cyprus**, British Virgin Islands and US leading to the identification of further assets totaling over £20 million. These additional assets had been purchased using funds gained from the earlier Operation Auchintoul fraud and the defendant's control of funds derived from two further MTIC frauds leading to the beginning of a separate money laundering investigation. Evidence was heard in the Confiscation case at Edinburgh High Court in May and November 2006.[38]"

- Shell companies are an attractive vehicle for money laundering purposes. **The control of companies in Cyprus has been demonstrated insufficient** – both for currently registered legal entities, and to an even greater extent, for existing companies incorporated at a time when AML requirements were very lax. Although Cyprus authorities claim that they are determined to address the issue of transparency of beneficial ownership for businesses operating in and from Cyprus, the possibilities to abuse such vehicles for illicit activity are still significant.

Shell companies are business entities with limited activity (or without activity) and no significant assets. Typically, they have no physical presence other than a mailing address and have no employees. Shell companies often have legitimate purposes: conduct asset transfers, cross-border currency transactions, or to facilitate corporate mergers and acquisitions. But in many money laundering schemes, shell companies appear as major actors in the recycling process. Typically, shell companies are being used as parties in international wire transfers by unknown beneficial owners, thus layering the financial transactions to launder criminal proceeds and reduce their traceability.

Case Study 9: Suspicious Wire Transfers Schemes Between the United States and Cyprus

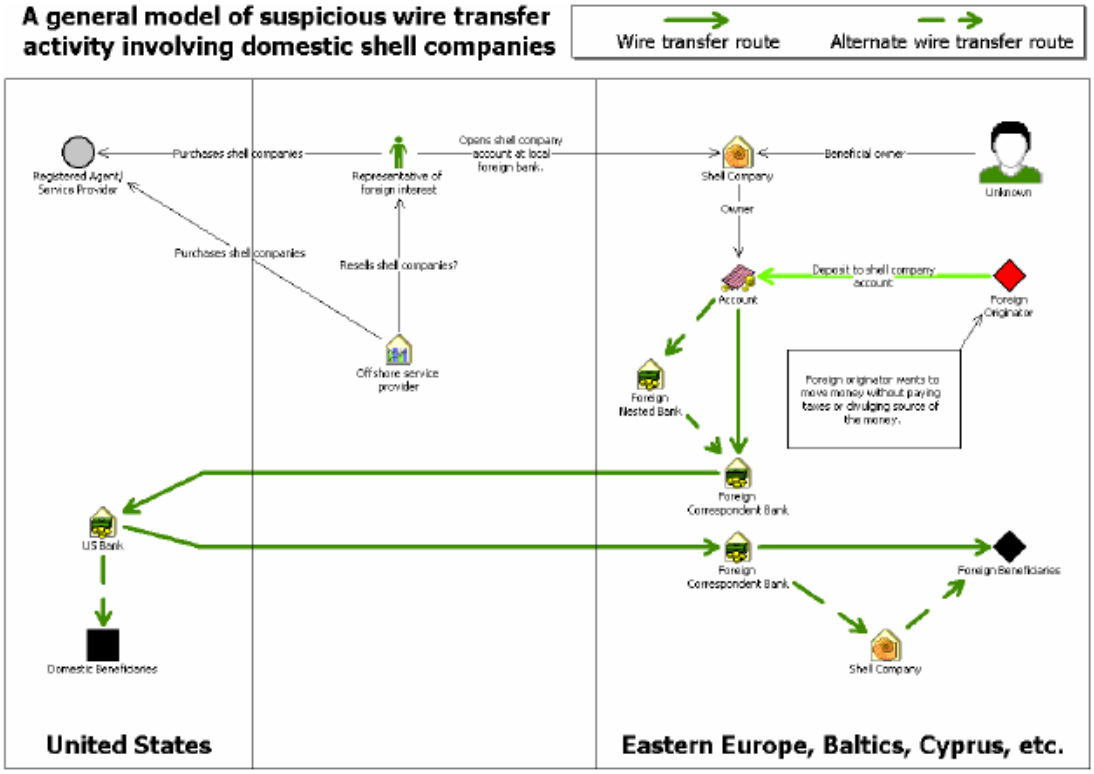
In November 2006, the US Financial Intelligence Unit ("FinCEN") released a report on "The Role of Domestic Shell Companies in Financial Crime and Money Laundering[39]". The report reviews the vulnerability of certain US states based on their corporate business laws and in particular, the limited liability companies, which have been used in money laundering schemes. Then it provides an analysis of the 1,002 Suspicious Activity Reports ("SARs") filed from 1996 through the beginning of 2005 involving the use of shell companies. Out of the 1,002 SARs studied, 768 involved suspicious

[37] Issue N°15, 10 March 2005
[38] Issue N°31, 30 January 2007.
[39] http://www.fincen.gov/LLCAssessment_FINAL.pdf

international wire transfer activity (often a wire transfer from a suspected shell company formed in the United States that had opened accounts in Eastern Europe). **185 SARs identified Cyprus as location of activity. As a matter of fact, Cyprus ranked fourth in terms of frequency of occurrence,** behind Russia (504 SARs), Latvia (449 SARs), and China (199 SARs).

According to FinCEN, "the wire transfers described in many of these SARs originated at accounts in Russia or Latvia [or Cyprus] held by what appear to be US shell companies, passed through the correspondent accounts of major US banks or branches of foreign banks, usually in New York, and then were sent back overseas, often to a wide variety of beneficiaries in many locations[40]". In most cases, the bank which filed the SAR was just a middle link in the wire transfer chain and there was little information on the originator and beneficiary entities. Therefore, definitive identification of shell companies solely from wire transfer records is hardly ever possible.

The graphic below illustrates FinCEN's description of the typical flow of funds in such a money laundering pattern and helps to illustrate why money laundering remains an issue for Cyprus:



Source: FinCEN

There are at least two lessons to be drawn from FinCEN's findings:

1. First, as already pointed out, the issue of monitoring the legal entities incorporated in Cyprus, and in particular companies in various forms, is the most important challenge of the fight against money laundering on the island. Ensuring transparency of beneficial ownership and checking records of existing companies is a gigantic task as thousands of companies have been created over the past few decades.

2. Second, now that Cyprus authorities have expressed their willingness to play their part in the European and global efforts to curb money laundering and financial crime, that they have enacted AML legislation and dealt with domestic ML cases, the coming years will be essential to test the ability of Cyprus' authorities to provide accurate and timely information to foreign law enforcement and be really efficient to this end. Cyprus is at a crossroads and by 2009-2010, there should be high profile money laundering cases

[40] FinCEN op. cit. pp. 11, 12.

successfully prosecuted in Cyprus and abroad with the help of Cyprus' law enforcement. If not, legitimate questions regarding Cyprus' ability and/or political willingness to fight money laundering will have to be raised with the island's authorities.

- In **major business deals** (not necessarily of criminal nature) **often involving former USSR countries as players, some sort of company incorporated in Cyprus typically appears when there is an obvious quest for opacity**.

This is exemplified by two recent cases currently under investigation to look into possible criminal activity.

Case Study 10: The "Gas Connection"

This case involves a suspect multibillion-dollar Gazprom deal to supply gas to Ukraine, and is allegedly linked to one Ukrainian organized crime group headed by Semion Mogilevich (previously mentioned in Case Study 5). An ongoing US investigation is checking on connections between Mogilevich and **Highrock Holdings Ltd., a Cyprus-registered company** that has played a role in several major energy deals. Highrock Holdings, which has operations in Moscow, Tel Aviv and Kiev, ships natural gas to Ukraine and other Eastern European countries over pipelines owned by Russian company Gazprom, and supplies Turkmenistan and other Central Asian gas producers in exchange for natural gas.

According to *The Wall Street Journal*[41] which reported on the case and the US side of the investigation, there has been at least one connection between Highrock and Mogilevich through the latter's wife. Until June 2003, Semion Mogilevich's wife and the wife of one of his associates, Igor Fisherman (indicted in 2002 in Philadelphia together with Mogilevich on charges of money laundering and securities fraud in connection with the collapse of a Pennsylvania-based company registered in Canada - YBM Magnex Inc.) were among Highrock Holdings Ltd.'s major shareholders. One of Highrock's shareholders was another Cyprus-registered company, Agatheas Trading Ltd., one director of which was Mogilevich's wife Galina Telesh. The two women are no more listed as shareholders and the ongoing investigation is trying to determine whether their husbands retain an interest in the company.

Highrock Holdings Ltd. is reported to belong now to another Ukrainian businessman named Dmytro Firtash. Firtash says Ms. Mogilevich and Ms. Fisherman are no longer shareholders in the company and that the two women were brought into shareholding by a former partner without his knowledge.

Firtash is also a major shareholder of another energy provider company, RosUkrEnergo ("RUE"). RUE came to light during the Ukraine-Russia gas crisis of January 2006, when Moscow cut off natural-gas shipments to Ukraine after a price dispute. RUE then came forward to act as a middleman and reached a compromise agreement between Ukraine's Naftohaz Ukrayina and Gazprom.

Swiss and Austrian-based RUE[42] was created in July 2004. Four days later, during a meeting in Yalta, Russian President Putin and former Ukrainian President Leonid Kuchma oversaw the signing of contracts between the new company, Gazprom and Naftohaz. RUE was set up to replace the discredited Eural Trans Gas ("ETG"), which had handled gas imports to Ukraine in 2003-2004. It nonetheless retained some of ETG's directors. ETG was founded in 2002 in a Hungarian village by an Israeli lawyer, Zeev Gordon. Mr. Gordon is reported to have represented Semion Mogilevich for more 20 years. Allegedly, Gordon had been asked to set up ETG by Firtash.

[41] US Probes Possible Crime Links to Natural-Gas Deals. The Wall Street Journal, Glenn R. Simpson, Dec. 22 2006.

[42] RosUkrEnergo AG was registered in the commercial register of the Swiss canton Zug on July 22 of 2004. Shareholders of the company are Gazprom and Raiffeisen Investment AG on the parity basis. Raiffeisen Investment is acting for two investors: Firtash (90% i.e. 45% of the overall shares of RUE) and Fursin for the balance.

In April 2006, *The Wall Street Journal*[43] reported that RUE was also under investigation by the US Justice Department's Organized Crime Unit. RUE's ownership is undeniably opaque, though further details of what has drawn the attention of US officials remain unclear. The company was known to be half-owned by Gazprom[44]. It was then revealed that Firtash was the second main shareholder, concealing his identity behind a trustee arrangement with the Austrian bank Raiffeisen Bank AG, which hold a 50% share in RUE on behalf of Mr. Firtash and a business associate identified as Ivan Fursin. Raiffensen Bank issued a statement denying media reports that Dmytro Firtash and Ivan Fursin might be connected to organized crime, saying the corporate-investigations company Kroll Inc. had checked them out and found no such connections[45]. Previously, doubts over RUE's ownership structure and affiliates had prompted its auditors from KMPG International to resign.

According to a Global Witness report[46], Firtash is also the chairman of Nitrofert (a fertilizer plant in Estonia). Nitrofert shares the same trading company ACI Trading as Crimean Soda Plant, owned by one of RUE's directors (Robert Shetler-Jones). **ACI Trading is reported to have the same Cyprus-based nominee shareholders as a series of investment vehicles that owned ETG in 2004, including Cyprus-based Dema Nominees and Dema Trustees.**

In conclusion, the story of companies involved in the natural-gas trade from Turkmenistan and Central Asia to Ukraine is very tangled. Global Witness' report contains detailed information on its months-long investigation, including field missions to check the premises of some of the involved companies. They concluded that **"all roads led to Cyprus[47]"** and that "the ownership of ETG had passed into the hands of several companies which were based in different **jurisdictions but linked back, via overlapping shareholdings and directorships to two holding companies in Cyprus[48]".**

The following is an excerpt from Global Witness report to exemplify how complex it is to deal with the issue of identifications of beneficial ownership and potential conflicts of interest between financial services providers and their clients:

"But investigations by Global Witness show that two of the new shareholders were ultimately controlled by the same **two holding companies in Cyprus** – **Dema Trustees Limited** and **Dema Nominees Limited**, and that the third shareholder was also indirectly linked to the Dema companies. The ultimate beneficiaries of Dema Trustees and Dema Nominees are unknown. This complicated structure obscures the beneficial ownership of ETG behind several layers of what appear to be mostly shell companies, often directed by proxies, and created or bought shortly before the takeover was effected[49]".

(…)

So who are Dema Trustees and Dema Nominees? Cypriote company records name their owners as Janet Demetriadou and Panayiota Piphani. Global Witness has established that Demetriadou and Piphani both work for a **Nicosia based accounting firm called Demetriades Shakos Piphanis**, which specializes in 'international tax planning' and sets up offshore companies in **Cyprus** in partnership with a firm that they direct called **Dema Services**, which has the same phone number as the accounting firm. Global Witness faxed questions to Demetriadou and Piphani, asking them about their involvement in the Dema companies, but neither replied.
Few other details are available about the companies, other than that **Dema Nominees** was previously called Byron Computer Products Ltd. Another accountant at Demetriades Shakos Piphanis, Andreas

[43] US Investigates Critical Supplier of Russian Gas. The Wall Street Journal, Glenn R. Simpson and David Crawford, April 21 2006.
[44] Gazprom owns half of RosUkrEnergo through an Austrian firm called ArosGas Holding AG, which is owned by Gazprombank.
[45] Investor Is Named in Energy Firm Mystery Ukrainian Holds Major Stake In Rosukrenergo. The Wall Street Journal, Glenn R. Simpson, David Crawford and Alan Cullison, April 27, 2006.
[46] It's a Gas. Funny Business in the Turkmen-Ukraine Gas Trade. 25/07/2006. Download on: http://www.globalwitness.org/media_library_detail.php/479/en/its_a_gas._funny_business_in_the_turkmen_ukraine_g
[47] Global Witness, Op. Cit. P. 44
[48] Global Witness, Op. Cit. P. 45
[49] Global Witness, Op. Cit. P. 41

Mavromatis, is a director of **Denby Holdings** and **Benam Holdings**, both of which also have Robert Shetler-Jones as a director.

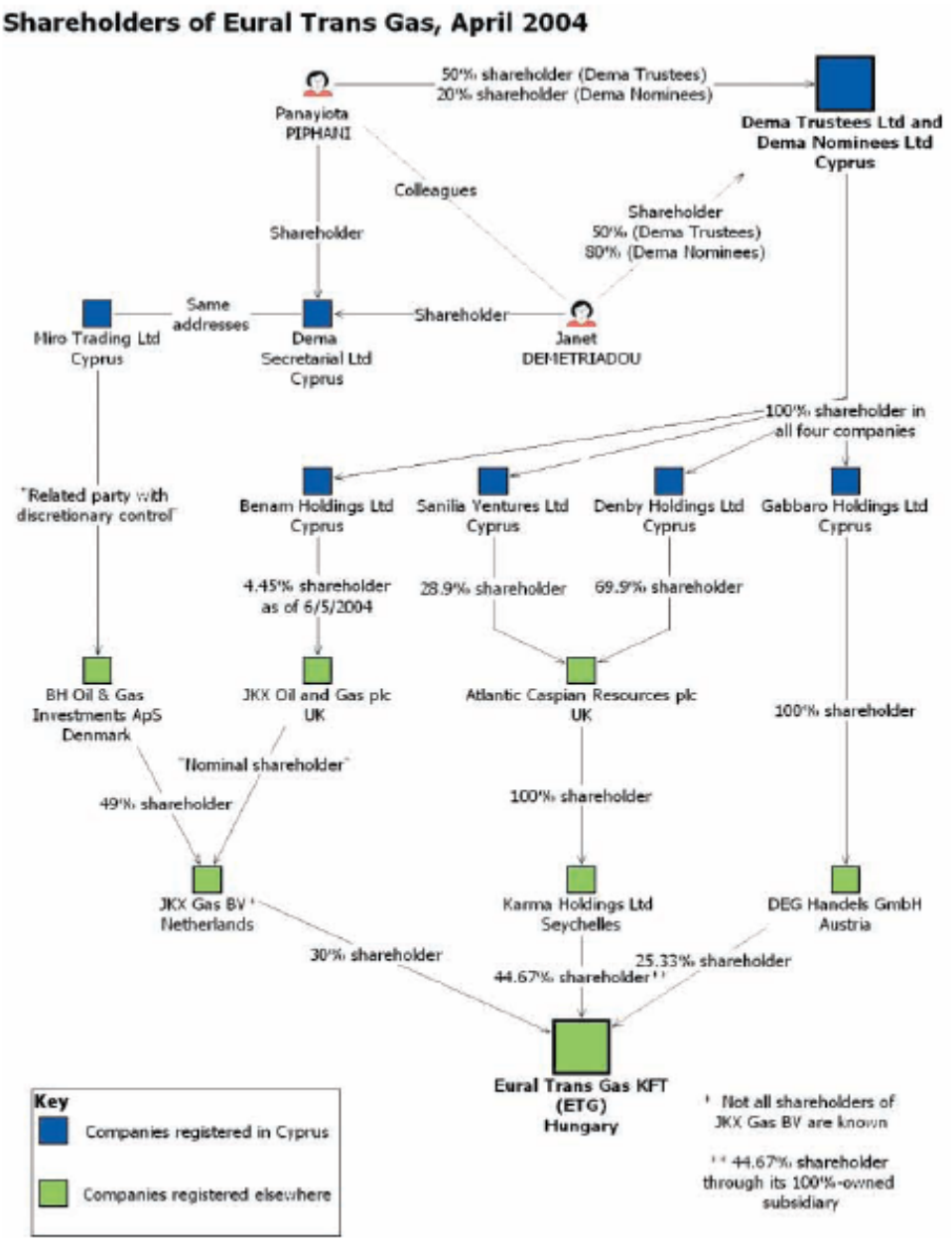
Global Witness called Mavromatis at his office to seek comment on the Dema companies, his relationship with Shetler-Jones and whether Mavromatis has any relationship with Dmytro Firtash, the man behind the registration of ETG. When Global Witness mentioned the words 'Ukrainian gas industry', Mavromatis abruptly passed the call back to a secretary who first claimed that he was 'on other business', then suggested he had passed the call back to her because he did not speak good English. Global Witness then faxed questions to Mavromatis, Demetriadou and Piphani. A Greek-speaking contact of Global Witness later phoned Mavromatis seeking comment on our questions. His secretary stated that the company would not be helping Global Witness with its research and asked us not to bother them again.

There is a business connection between the Dema companies, Ukraine and Dmytro Firtash, the founder of ETG. **Dema Nominees** and **Dema Trustees** are joint owners of a company called **ACI Trading Ltd**, whose director is Andreas Mavromatis. ACI Trading trades in chemicals and has a representative office in Ukraine. According to Global Suppliers online, a business website, ACI Trading's clients include the Crimean Soda Plant, which is 89% owned by RSJ Erste, Shetler-Jones' Hamburg-based company and the Nitrofert fertiliser plant in Estonia, whose chairman is Dmytro Firtash. These connections indicate that the Dema companies have indirect relationships, via ACI Trading, with companies controlled by Robert Shetler-Jones and Dmytro Firtash.[50]" (…)

Mavromatis and Shetler-Jones have another connection: the two men are both directors of a **Cyprus-based investment fund called Arcadea Investment Fund Limited**, which was created on 1st July 2004. Both Mavromatis and Shetler-Jones, along with Charles Treherne – an associate of Shetler-Jones' at Denby Holdings – and two other men were appointed directors of this fund on 24th June 2004. Information from Cyprus Central Bank.
See www.centralbank.gov.cy/media//pdf/CSLSE_ICISDETAILS0206.pdf[51]"

The following scheme from the Global Witness report shows the role of Cyprus-registered companies:

[50] Global Witness, Op. Cit. PP. 44-45
[51] Global Witness, Op. Cit. P. 63



Obviously, **the whole network of connections between the various players is very murky and Cyprus-registered companies have been and are likely still instrumental in taking cross stakes in many companies in and beyond the energy sector**. Worrisome, as *The Wall Street Journal* points out, is that through Mogilevich and possibly some Cyprus-based companies under his control, organized crime could be "spreading its influence in the energy industry" (…) "using its natural-gas profits to increase its economic and political clout in Europe and Russia[52]".

Case Study 11: illicit weapon sales from Ukraine to embargoed Iran

Cyprus companies have had a reputation of being instrumental in shadowy arms deals in the 1990s, with arms merchants from Russia, Ukraine and the Balkans using the convenient corporate and

[52] The Wall Street Journal, Dec. 22 2006. Op. Cit.

financial infrastructures that Cyprus offered at this time. It is impossible to assert whether effective arms dealing business is still carried out through Cypriote-based companies. The fact is that statistics relating to small arms imports raise unanswered questions. According to the Small Arms Survey 2006[53], Cyprus was ranked the second-biggest world importer of small arms and light weapons[54] for the year 2003 (while already ranking among top importers for the two previous years) behind the United States and before Germany. In its 2005 issue, the Small Arms Survey pointed out that "as in previous years, [Greek] Cyprus is among the top importers (…) this recurrent peculiarity is the consequence of an opaque transit trade. A lack of transparency characterizes [Greek] Cypriote reporting on the trade". The report further underlined the fact that Greek Cypriote small arms imports are from "unspecified" countries. There is very little additional information retrievable from open sources to sustain any serious explanation on Cyprus' role in the small arms trade. Anecdotal articles have regularly accused Cyprus of being involved in arms dealing business with the Russian mob. But although the compilation of different facts and figures can be disturbing, there is no hard evidence to prove so.

A Ukrainian government probe was opened by the Kuchma administration in 2004. It was made public in 2005 when a reserve colonel in the intelligence service (Hrihoriy Omelchenko) wrote to newly elected President Yushchenko asking him to pursue a full investigation. Omelchenko made his letter available to The Associated Press. In his letter, Omelchenko indicated that between 1999 and 2001, twenty KH-55 missiles had been recorded sold to Russia's Defence Ministry, but that through a false contract, end-user certificates had been forged and six missiles had purportedly ended up in Iran and another six had gone to China. The missiles supposedly sold to Iran were unarmed, but were designed to carry 200-kiloton nuclear warheads.

A number of companies were allegedly used to circulate funds relating to the transaction, including Cyprus-based Investworld Ltd., EMM Arab System Ltd. and S.H. Heritage Holding Ltd.

One of the players is a Russian national Oleg Orlov who owns **Cyprus-based EMM Arab System Ltd**. In 2001, Orlov and EMM Arab Systems Ltd. had already been involved in weapons and supplies sales to Angola's rebel UNITA group and implicated by a UN Security Council report. A UN Panel of Experts on Sierra Leone also stated that "Oleg Grigorovich Orlov is the subject of a government investigation in Kazakhstan into the smuggling of two Mi-8T helicopters out of the country. According to the Government of Kazakhstan, Orlov is active in the arms markets of the Confederation of Independent States, Syria, Sri Lanka, Pakistan, North Korea and certain African countries, including Eritrea. He is associated with the following companies: **Dunford-Avia Progress Ltd. (Cyprus),** Global Omarus Technology Ltd. lately renamed **EMM Arab System Ltd. (Cyprus),** Euroasian Financial Industry Group (Singapore and Malaysia), Belmont Trading and Gulfstream[55]". In 2000, Orlov and a Ukrainian partner identified as E.V. Shilenko allegedly exported the cruise missiles through the fake contract with a firm called Progress, a subsidiary of Ukraine's arm export agency Ukrspetseksport. Orlov was arrested in July 2004 in the Czech Republic where he reportedly survived an attempt on his life in the prison cell. He is awaiting extradition.

The other main player in this case is the **Cyprus-based company S.H. Heritage Holding Ltd.**, previously owned by an arms merchant named Sarfraz Haider, an Australian citizen of Iranian-Afghan origin. Haider died in a car accident in Cyprus in 2004. Unchecked information reports that the autopsy revealed that his neck had been broken and his aorta split. Rumor says that he has been murdered for knowing too much about the deal with Iran.

Omelchenko also reported that in March 2001, a trip to Iran was organized for Ukrainian specialists to technically service the missiles. The trip was arranged through a **Cyprus-Limassol-based company Volgen Trading Ltd**., the founder and director of which is another Russian citizen named Gennadyi Shkinyov. At the request of Ukrainian authorities, Shkinyov is being investigated by Cyprus' law enforcement agencies.

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[53] The Small Arms Survey is an independent research project located at the Graduate Institute of International Studies in Geneva, Switzerland. It is a reliable provider of statistics and information on all aspects of small arms.

[54] Imports amounted to US$ 228 in 2003, latest figure available. The legal global small arms market is estimated at $4 billion and the illegal market is estimated at close to $1 billion.

[55] Report of the Panel of Experts appointed pursuant to UN Security Council Resolution 1306 in relation to Sierra Leone, Dec. 2000.

Law enforcement authorities of the countries involved have expressed concerns not only about continued arms trading, but also about the location of funds in connection with the illicit traffic. Cyprus' authorities have reacted by offering full support in the probe.

CONCLUSION

Despite apparent efforts to develop and implement a robust anti-money laundering regime, Cyprus remains vulnerable to money laundering. The coming years will be crucial to test the authorities' ability and willingness to discourage shady customers from abusing the island's financial infrastructure and to successfully prosecute increasingly complex money laundering cases.

Cyprus' authorities have taken very seriously the multiple adjustments necessary to join the European Union. New pieces of legislation, encompassing economic and financial matters, have been enacted and are being enforced. Sacrifices have been made regarding, *inter alia*, the offshore regime. EU membership is bringing a heavy stream of new opportunities to Cyprus, and public and private sector leaders are altogether confident that their AML efforts are going to pay back.

Let us therefore discard the hypothesis that Cyprus authorities might be playing a deceptive game and falsely be pretending to comply with new AML requirements in order to cover up the bigger money laundering schemes. Authorities have for the most part, demonstrated a strong willingness to meet most criteria required to join the EU and have too much to loose to be caught at fault. Second, it would be an unsustainable posture to hold in the long term because of the international focus on and monitoring of money laundering and terrorism financing.

Cyprus' establishment pays a great deal of attention to its image: the years when the island's authorities did not care to be considered a safe haven for dubious business are long gone. On the contrary, they work hard to be considered one of the best "pupils in the class" of newly acceded EU countries. Whenever Cyprus is under fire, they strongly and publicly react to deny any wrongdoing and insure their partners that they are committed to fight international crime, corruption, terrorism, etc.

As a consequence, mission teams of international evaluators who have come to review the island's financial sector and anti-money laundering framework have received full support and cooperation from the Cypriote administration. Assessment reports have demonstrated that Cyprus had put itself in compliance with international anti-money laundering standards. Whenever weaknesses have been identified by the assessors, Cyprus' authorities have responded by making the necessary changes in the regulatory framework (in particular, the Guidance Notes for professionals subject to the AML legislation), or functioning of internal coordination and supervision bodies. Last, human and financial means to combat money laundering have been increased. It is expected that amendments to AML legislation be passed by the end of 2007, in line with the requirements derived from the EU's Third Directive.

This said, attention must be paid to appearances. Indeed, Cyprus' AML problem does not lie in the legislative and regulatory framework to combat money laundering and financial crime: the central issue is enforcement. One negative effect of AML assessments done by the FATF and FATF-Style Regional Bodies[56] ("FSRB") is that all attention is focused on the compliance issue rather than on enforcement. Although the implementation of the AML regimes is also partially assessed by international bodies, this is done without really digging into the reality of business, cultural practices and domestic particulars.

The fact that Cypriote officials continue to minimize the island's recent history, rather than confront directly the attitudes and practices that allowed illegal money laundering to flourish, creates skepticism about their ability to now grapple with these underlying conditions, many of which may still exist despite recent efforts to mitigate the island's exposure and vulnerability to financial crime.

[56] MONEYVAL is the FSRB for Europe.

Realistically speaking, Cyprus' comprehensive AML framework is only the very first step needed to prevent, detect and punish money laundering. Cyprus' authorities have been commended by international evaluators for their effort to bring the island to international standards. From now on, the pressure needs to shift from being apparently compliant to being efficient in reality.

First, Cyprus' AML regime is not consistently designed, applied and enforced across subject professionals and sectors. A first distinction has to be made between banks, whose AML regime is very sophisticated and closely monitored, and other players in the financial sector. *A fortiori*, "gatekeepers" professions are difficult to bring into the AML game and even trickier to supervise. Increasingly, money launderers seek out the advice or services of these specialized legal and financial experts to help facilitate their financial operations because they are aware of such loopholes. Lawyers, in particular, have proven difficult to deal with as far as their compliance to the AML regime and their disclosure of suspicious activity is concerned. The supervision of Cypriote lawyers with respect to their AML obligations raises concerns as the Bar Association is so far refusing to conduct on-site inspections. Cyprus' relatively small business community has advantages and drawbacks: abnormal behavior or transactions are detected without delay, but the "*omerta*" rule (no disclosure to anyone alien to the family) is easier to enforce.

Secondly, Cyprus has inherited a situation whereby thousands of companies have been created in the last two decades and international corporations have long used the island's financial and legal infrastructures to do offshore business. This business, though requiring the highest confidentiality, is legal most of the time. Let us assume that Cyprus' authorities want to sort out this international stream of business, break with habits from the past, and concentrate on high value-added services for "clean" customers. There are nonetheless two pending issues, requiring a very close monitoring for the coming years:

1. Can Cyprus insure that existing structures are no longer controlled and used by criminal interests to launder illegally gained funds? A related question is whether organized crime has really deserted the island to delocalize its financial activities and to move it to less exposed places?

And,

2. Are the supervisory authorities and law enforcement capable of dealing with increasingly complex cases?

Domestic law enforcement is still at an early stage of its learning process with respect to international cooperation aspects which are central in money laundering cases. The coming years should see successful prosecution of money laundering cases based on foreign predicates and if not, a detailed assessment of the functioning of the law enforcement chain will be needed.

The issue of identification of beneficial ownership is not completely solved legally and administratively. Worse, the verification of existing legal entities, some of them long registered in Cyprus, is a colossal time and money consuming task. Meanwhile, criminals can continue using Cypriote front companies. Straw men working for transnational organized crime groups would likely go undetected if they are long-standing customers who have built over the years a trustful relationship with financial and legal services providers.

That said, organized crime goes where its best interests lie: if launderers and shady businessmen are harassed with red tape and compliance procedures, it is likely that they will move their business to other places. For example, Russian business in Belize is reportedly booming.