

West's Sanctions Turn Investors Into Investigators

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The announcement of sanctions last month by the U.S. and the European Union in response to the Russian annexation of Crimea once again saw the role of a regulator being transferred from the government to the private sector.

The sanctions target major public and private figures in Russia and Ukraine, including members of President Vladimir Putin's inner circle. Any company doing business with entities majority-owned by these "specially designated nationals," or SDNs, will be in breach of sanctions.

Sanctions are not a new concept. Most U.S. and European companies operating internationally already use internal compliance procedures to raise a red flag when a sanctioned entity approaches their business. In many ways, these additions to the sanctions lists are no different.

But there are two important differences. First, it may never be possible to assemble

a complete, evidenced picture of the assets owned by the Russian and Ukrainian SDNs thanks to the way business is traditionally conducted offshore. As a result, the international business community will struggle to know with certainty whether it is doing business with a sanctioned individual or entity.

Second, the enforcement of these sanctions has essentially been outsourced to the private sector. The international business community has to investigate whether any of its relationships harbor the undisclosed presence of an SDN. The extensive use of complex offshore business structures favored by business in the post-Soviet space makes this a particularly difficult task.

Corrupt Ukrainian and Russian political and commercial figures have long exploited offshore ownership networks for hassle-free company formation and the concealment of beneficial ownership. Working through this legal and commercial smokescreen is not easy. Diligent EU and U.S. companies reviewing Russian corporate filings for a clear picture of an SDN's footprint in Russia are likely to be disappointed.

This is not because Russian corporate databases are poor; in fact, they are far more transparent and user-friendly than many EU equivalents. The disappointment arises elsewhere. Anyone on the sanctions list who has already managed to conceal assets from the Russian media, from various anti-corruption campaigners and from the Kremlin's anti-corruption campaign will not be worried that sanctions will suddenly expose them. They have relied on the legitimate services of providers of offshore company registration services to ensure there is no conclusive proof of their ties to the companies they own.

Where are most of these offshore providers? Ironically, they are primarily within the sphere of influence of the U.S. and EU. Cyprus, the British Virgin Islands and the Bahamas are just a few examples of low-disclosure jurisdictions beloved by the Russian and Ukrainian elite. So, while the private sector has to comply with sanctions imposed by international regulators, the regulators have failed to address the system that provides shadowy coverage to the actual targets of sanctions. With one hand, international regulators are taking from SDNs the chance to operate internationally. With the other, they offer them the very means to evade detection. Until international regulators come together with the same determination currently applied to SDNs to wipe out the offshore system, corruption, tax evasion and money laundering will continue to thrive.

In the eyes of Western governments, the sanctioned individuals are at the heart of the corrupt former Ukrainian regime. For years, international corruption watchdogs have lambasted Ukrainian politicians as corrupt business deals diverted public funds through a network of opaque entities in exotic jurisdictions, leaving the country close to bankruptcy. Most recently, documents from former President Viktor Yanukovich's opulent country residence show that his son Oleksandr was the ultimate beneficiary of a coal trading company that regularly won state tenders. On paper, this company was controlled by a seemingly unrelated offshore firm in the British Virgin Islands.

Russian officials and businessmen on the sanctions lists fall roughly into two groups. Some of them will have been the first to comply with Putin's recent "de-offshorization" initiative as a show of political loyalty and patriotic fervor. Others will have structured their businesses

to ensure that no paper trail will ever conclusively show the beneficial ownership of their companies.

Anti-corruption crusaders like Alexei Navalny have focused much attention on wastage and the theft of state revenues in Russia. Putin himself has spearheaded an anti-corruption campaign — arguably in response to the pressure from the 2011-2012 protests. Regardless of the motivations, these activities are leading to a shift in attitudes toward corruption at the highest echelons of power in Russia. Some extremely high-profile and well-protected figures have fallen victim to dramatic public prosecutions. Since former Defense Minister Anatoly Serdyukov was publicly humiliated and linked to corruption charges, politicians and businesspeople outside the Kremlin's innermost circle are slowly coming to comply with the new rules.

Last year's muted efforts by the Group of Eight to bring greater transparency to offshore structures to tackle tax evasion failed to take into account the other reasons these structures are so appealing to less scrupulous operators. Offshore companies are specifically structured so that even the best resourced and connected law enforcement agency will never identify the ownership of a company by following the paper trail alone.

In imposing sanctions in Russia and Ukraine, it is unlikely that the EU and the U.S. are out to trap the international business community. At the same time, however, more than a token effort will be required to convince regulators that companies have taken steps to avoid doing business with SDNs.

While compliance with anti-corruption laws demands that global businesses take adequate measures to know who stands behind their commercial partner, Western sanctions ask investors to step into the shoes of law enforcement to comprehensively research and review all existing business partners for potential ties to the SDNs. This is a mammoth task indeed.

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