

**“The Medvedev Thaw: Is it real? Will it last?”**  
**Commission on Security & Cooperation in Europe – the U.S. Helsinki Commission**

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**Testimony of William Browder**  
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Mr. Chairman and Distinguished Members of the Commission, thank you for inviting me to appear before you today.

I have been asked to share my thoughts on the rule of law in Russia. Unfortunately, my own personal experience shaped by fifteen years of investing in that country confirms to me that the situation in Russia is not a pretty picture, and it is getting worse.

When I first started Hermitage in the mid-1990's, my clients would ask me about the Russian horror stories they had heard of shareholders getting wiped off corporate registries, having assets stolen by crooked management or being the targets of corrupt government officials seeking bribes. What I was able to tell my investors back then is that while corporate governance was terrible, valuations were cheap, and investors would make money as Russia evolved from “horrible” to just “bad.” I am here today to tell you that Russia is reverting. The investor horror stories that were largely fantastic in the 1990's are now commonplace. The situation in Russia is going from “bad” back to “horrible” – and it will be more than just investors who lose out in this process.

If there is one image I want to leave you with today, it is this. In most countries of the world, the spheres of business executives, government officials and criminals don't typically overlap. In Russia, these three groups have become essentially indistinguishable. All too often in today's Russia, there is no contradiction in someone being a business executive, senior government official and crime boss all at the same time.

**Hermitage Capital and Shareholder Activism**

Speaking before you today carries on a family tradition of sorts. My grandfather, Earl Browder, was the head of the American Communist Party and appeared before his fair share of Congressional committees over the course of his lifetime. He had met my grandmother during his travels in the Soviet Union, so you could say that Russia and populist politics were in my blood. As the family rebel, however, I decided to go to an American business school and ultimately went back to Russia following the collapse of the Soviet Union to build a business.

I founded Hermitage in 1996 in partnership with the late Edmond Safra as a way for western investors to invest in the Russian stock market. The firm ultimately grew to become the single largest foreign portfolio investor in Russia, with some \$4 billion under management in 2006, a substantial portion of which came from U.S. institutional and individual investors. One of the big reasons for the firm's success was our strategy of investing in the stocks of companies that were out of favor due to bad management, corruption, shareholder rights

abuses or outright theft. We would then work to change management, stop fraud and defend the interests of minority shareholders through shareholder activism. If we were successful in improving corporate governance, the market would ultimately recognize this. As the company came back into favor, its stock price would rise, our investors would profit and the Russian economy would be better off for having a more productive, transparent economy. For several years it was a win-win situation for everyone except corrupt corporate management and their partners in government.

Due to weak courts and legal protections, our biggest leverage was often the bully pulpit of the press. Since 1996 we waged dozens of high-profile public activist campaigns targeting mismanagement and corruption at some of the largest companies in Russia. These included Gazprom (the state-controlled natural gas monopoly), Unified Energy Systems (the national electricity utility), Sberbank (the largest bank in Russia) and Surgutneftegas (the fourth-largest oil company in Russia).

Most of the companies we sought to reform were controlled by the Russian government, and in the course of our anti-corruption work, Hermitage stepped on many high-placed toes. In November 2005, I was suddenly denied entry at Moscow's Sheremetyevo Airport and despite prominent intervention and support both here in the US and in Europe, my visa has not been restored. Regardless of my being the single largest stock investor in the country, and despite having attracted billions of dollars of capital into the Russian economy over the past decade, the Russian Government banned me from entering the country in the interests of "national security, public order or public health."

While working to regain my Russian visa, I had the opportunity to approach then First Deputy Prime Minister – and now President – Dmitry Medvedev at the World Economic Forum in Davos, Switzerland in January 2007. I asked him for help in restoring my visa. He asked for my documentation and said he would look into it. Unfortunately, what happened next was worse than losing my visa in the first place.

### **Company Theft: the Fraud against Hermitage**

While it was shocking to be effectively deported from Russia, the visa denial was only the prelude to a story that sheds light on the shocking state of the rule of law in modern Russia. Shortly after Davos, a colleague received a call from a Lieutenant Colonel in the Russian Interior Ministry, Artem Kuznetsov. He said he understood that I was seeking to return to the country and suggested to my colleague that they have an informal meeting. Kuznetsov further explained that the status of my visa application would "depend upon how we behaved and what we provided." We considered this request very suspicious because one never had "informal meetings" with policemen, and his reference to us "providing" him things appeared to us to be an outright extortion attempt. When we asked for his questions in writing, he refused to provide them, and we never agreed to meet.

Soon thereafter, on June 4, 2007, Lieutenant Colonel Kuznetsov led a team of 25 Interior Ministry officers on a raid of our Moscow offices. They seized all of our computers, network servers and documents – in total two van-loads of materials. Kuznetsov left the Hermitage raid mid-way through to join another raid that was taking place simultaneously at the offices of Firestone Duncan, an American-owned Moscow law firm that advised on Russian legal and accounting affairs for the Hermitage Fund. In this raid the Interior Ministry removed files

that contained the stamps, seals, original articles of association and other statutory documents for the Fund's Russian investment companies. One of our lawyers protested to the Interior Ministry officers that the raid and the seizure of these materials violated Russian law. He was taken into a conference room, beaten viciously by the officers and arrested. After being hospitalized for two weeks, he was forced to pay a 15,000 ruble fine.

Shortly after the raid, Kuznetsov went on a "fishing expedition" to try to find where the Hermitage Fund held its assets in Russia. He visited the Moscow offices of Citibank, Credit Suisse, HSBC and ING with a list of Hermitage entities, both foreign and Russian, and demanded that these banks release all of their records relating to them.

As this was happening, the ownership of three Russian investment companies of the Hermitage Fund was fraudulently transferred from HSBC, as trustee of the Hermitage Fund, to an unknown company called Pluton based in the Republic of Tatarstan, Russia. The owner of Pluton was a man named Viktor Markelov, a criminal convicted of manslaughter who had recently served time in Russian prison. In addition to himself, Markelov appointed two other men, Vlyacheslav Khlebnikov and Valery Kurochkin, a convicted burglar and a convicted thief, respectively, to be the directors of the stolen Hermitage companies.

So the implausible horror story of being "wiped off the corporate registry" that had been on the minds of my early investors more than 12 years ago was now coming to fruition. A scenario that had never occurred during the "lawless chaos" and "Wild East" of the Yeltsin years was now taking place under the "law and order" regime of Vladimir Putin.

In order to change ownership of a Russian company, one needs to have the original charter, corporate seal and certificate of registration of that company. All of these documents and seals had been taken by the Moscow Interior Ministry during the raid on our lawyers' offices in June 2007, and they were in the Interior Ministry's possession when this fraudulent transfer took place.

Even before they were illegally installed, the new "owners" of the Hermitage companies drafted several fake and back-dated contracts with a Russian shell company called LogosPlus that we had never heard of and never done any business with. On the basis of these new "unfulfilled" contracts, LogosPlus alleged that the Hermitage companies now owed it hundreds of millions of dollars. LogosPlus then sued our companies in St. Petersburg Arbitration Court, claiming huge damages. Neither we nor HSBC were notified of these claims since the registered addresses for the companies had been fraudulently changed along with the other ownership details. A team of lawyers we had never met appeared in St. Petersburg claiming to represent the (former) Hermitage companies in the proceedings. These lawyers pleaded guilty, "fully accepting" all of the claims and consented to the court's judgment of \$380 million in damages against the Hermitage companies.

The court proceedings themselves were riddled with peculiarities. We later discovered that the LogosPlus claims were filed by an individual using a stolen passport. In its complaint, LogosPlus was claiming to be the counterparty to a \$500 million stock trade despite having a charter capital of only \$350. Moreover, the unknown lawyers who materialized in court to act on behalf of our stolen companies were relying on forged powers of attorney and other documents that bore an uncanny resemblance to the materials seized by the Interior Ministry in its June 2007 office raids.

At first, the perpetrators' plan appeared to be to get bogus court judgments and then use these judgments to seize any assets they found. Their hope appeared to be that the asset searches carried out by Lieutenant Colonel Kuznetsov at Citigroup, Credit Suisse, HSBC and ING between June and August 2007 would yield a jackpot of assets. Unfortunately for them, all our assets had been moved out of Russia into safe and lawful jurisdictions after my Russian visa was revoked, and the perpetrators got nothing from us.

### **\$230 Million Tax Rebate: the Fraud against the Russian State**

That seemed like it should have been the end of our troubles in Russia, but it wasn't. In late March last year we discovered that two new cases identical to those in St. Petersburg had been filed against our Russian companies in Moscow and Kazan. Unknown lawyers appeared on our behalf and admitted full liability to unknown claims arising out of contracts we never signed with companies we had never heard of. In total, together with St. Petersburg, judgments totaling \$973 million were issued against the Hermitage Fund companies in this manner. What was particularly disturbing about this new discovery were the dates when the cases were filed. They had been filed on October 19, 2007 in Moscow and October 22, 2007 in Kazan – more than a month after Kuznetsov's asset search had yielded no results. It seemed strange and worrying that the perpetrators would continue to be so active filing fake cases against our companies when it was clear at this point that they would not be able to seize any assets since these companies were empty. We did further investigations to try to understand what their motivation was.

The whole story started to make sense in June 2008 when we received information regarding our three stolen companies from the Russian company registration database. We learned that the perpetrators had opened new Russian bank accounts for the three stolen companies in December 2007. Two of the companies set up accounts at Universal Savings Bank ("USB"), and the third company opened an account at Intercommerz Bank. Both banks were tiny by any measure. USB had total capital of \$1.5 million, and Intercommerz had capital of \$12 million. Looking more closely at the banks' disclosure statements on the Russian Central Bank's website, we learned that the aggregate customer deposits increased by 623% at USB and 273% at Intercommerz shortly after our stolen companies had opened their accounts. What was truly chilling were the amounts by which the banks' deposits had increased. USB's deposits had grown by \$97 million and Intercommerz's by \$143 million – roughly the same amounts that the Fund companies paid in capital gains tax to the Russian government in 2006.

In light of this disturbing coincidence, we dug deeper to see if there was any more detailed information about the spike in deposits at the two banks. We learned that two of our stolen investment companies were the largest and second largest depositors at USB with a combined \$91 million in their accounts, and our other stolen company was the largest depositor at Intercommerz with \$139 million in its account. The size of each of our stolen companies' deposits was exactly equal to the amount of tax it had paid in 2006 to the Russian budget.

The whole story now fell into place. In short, after the straightforward asset seizure failed because our companies were empty, the perpetrators set out to steal the Russian income taxes the Hermitage Fund had paid in 2006. How did they do this? They had obtained the above-mentioned sham court claims that were exactly equal to the 2006 profits of the Hermitage

companies. Our three companies had combined profits of \$973 million that year, and the fake court claims from Moscow, Kazan and St. Petersburg totaled \$973 million. By burdening our companies with these new “claims,” the perpetrators went back to the tax authorities and filed amended tax returns with additional “losses” that reduced the companies’ profits to zero. On the basis of the restated results, the perpetrators filed for a refund of the income taxes that the Hermitage Fund paid in 2006 (\$230 million). The tax authorities approved the refund on the same day and paid it out to the perpetrators in a record two days via the newly opened accounts in these tiny Russian banks where there were further channeled abroad via correspondent dollar accounts with U.S. banks. With the refund money deposited in the banks, the perpetrators could wire it wherever needed, complete the fraud and then cover their tracks. Indeed, one of the banks – USB – has since been liquidated and has effectively ceased to exist.

### **The Russian Government’s Response**

So the two-pronged scam worked in one area and failed in another. The perpetrators weren’t able to steal the assets from us based on the fake court claims, but they were able to steal \$230 million from the Russian government by filing amended tax returns on behalf of our stolen companies. What makes this story even more shocking is that we filed six 255-page criminal complaints with the Russian authorities in early December 2007, several weeks before the tax fraud took place, and they did nothing to stop it. Two complaints were sent to the Russian General Prosecutor, two to the Russian State Investigative Committee and two to the Internal Affairs Department of the Interior Ministry. There was enough information to prevent the fraud and indict a number of people behind it if the Russian government had acted.

Instead of doing anything to save the Russian state from this highly sophisticated and organized looting, two of our complaints were thrown out immediately; two were returned to the same Interior Ministry officials we were complaining about (essentially, they were being asked to “investigate themselves”); and one was thrown out for “lack of any crime committed.” Only one complaint was taken seriously. It was taken up by the Russian State Investigative Committee in early February 2008, but before it could get any traction, the case was transferred to the Southern region of the Moscow district of the State Investigative Committee (the lowest possible level of the Committee) and by June 2008, a senior Interior Ministry official who had been named in the complaint, Lieutenant Colonel Kuznetsov, had joined the “investigation” team (again, essentially to “investigate himself”). We were later not surprised to learn that this investigation was closed in October 2008 due to the “absence of a crime.”

The reactions from other “interested” arms of the Russian government have been equally perplexing. As for the Tax Ministry, the authorities in Moscow who approved the fraudulent \$230 million refund have stated they were misled and supposedly only learned about the fraud in February 2009, despite the complaints we had filed with them in 2008 requesting that they investigate the fraud. We wrote about the \$230 million fraud to the Russian Audit Chamber (the body responsible for overseeing the proper disbursement and safekeeping of state funds), but they responded it was outside the scope of their official responsibilities. We alerted all nineteen members of President Medvedev’s Anti-Corruption Commission about it, but we received no substantive response. We wrote to the Russian General Prosecutor, the Russian State Investigative Committee, the Minister of Finance, the Minister of the Interior,

the Head of the Federal Tax Authority, the Head of the Federal Security Service (FSB) and the President's office in the Kremlin. Again, we received no substantive response. It appeared that not a single Russian official was interested in looking into how \$230 million had disappeared from the Russian treasury.

### **Retaliation by the Interior Ministry**

Incredibly, the only serious response by the Russian authorities to this massive fraud against the Russian state has been to attack Hermitage executives and the lawyers in Russia who are defending the Hermitage Fund and ultimately to blame some of the victims – HSBC and Hermitage – for the fraud itself. These cases appear for all intents to be a crude form of retaliation against Hermitage for shining light on the \$230 million fraud against the Russian government.

Once HSBC and Hermitage began to file complaints spelling out the fraud and identifying some of the key perpetrators to the Russian authorities, the Interior Ministry began to retaliate – first, against myself and my colleagues at Hermitage. Shortly after complaints were filed in December 2007 alerting the authorities to the massive fraud underway, representatives of the Moscow Interior Ministry travelled to Kalmykia, a region in southern Russia, where the Hermitage Fund had investment companies in 2001 and where I had served as a director. These Interior Ministry officers called a senior investigator of the Kalmyk Interior Affairs Department back home from vacation and instructed him to open two cases alleging tax offences in 2001 (this is despite the fact that there was no legal basis for these claims and the applicable statute of limitations had expired in 2004).

The cases were opened on February 27, 2008, and my name was added to the National Search List in Russia. The legal process of opening an official investigation that can typically take up to two months transpired in a single day. The local investigator later confirmed to my Russian lawyer that the reason he was asked to open the investigation was to enable the Interior Ministry to place me on the national and international search lists, including the Interpol 'Red Notice' search system.

Similar steps were taken against my Hermitage colleague, Ivan Cherkasov, who served as the general director of a local investment company on behalf of a Hermitage client. Here, the Interior Ministry has sanctioned an investigation alleging that this company underpaid dividend withholding tax, despite the fact that the company had conducted regular quarterly audits and the Russian tax authorities had confirmed in writing that the taxes were paid in full. Indeed, in the course of a subsequent statutory tax audit, the tax authorities discovered the company had actually *overpaid* its taxes and was owed a refund of 3.8 million rubles. Nonetheless, this Interior Ministry investigation remains "ongoing," and Cherkasov also is on the Russian National Search List. Interior Ministry investigators have issued public statements to the Russian press that their objective is to issue arrest warrants for us and to do so *in absentia*.

The retaliatory attacks were not isolated simply to Hermitage executives but were also targeted against the lawyers in Russia acting on behalf of the Hermitage Fund. The intimidation and harassment began last year, when on the night of August 20, 2008, the Moscow offices of four law firms representing HSBC and the Hermitage Fund were raided

by Interior Ministry officers. In addition to confidential client files, the officers seized original powers of attorney that our lawyers were going to use in court the following day.

The additional experiences of two of our Russian lawyers, Sergey Magnitskiy and Eduard Khayretdinov, are particularly illustrative. Shortly after Magnitskiy testified about the role of Interior Ministry officers in the fraud, he was arrested. Shortly after Khayretdinov filed complaints on behalf of HSBC and the Hermitage Fund implicating Interior Ministry officers, a retaliatory criminal case was opened against him.

Sergey Magnitskiy is a legal and accounting adviser with Firestone Duncan. In the course of his work defending the Hermitage Fund, Magnitskiy uncovered the information about the theft of the Hermitage Fund companies and the fraudulent tax refund that formed the foundation of criminal complaints filed by HSBC with the Russian authorities on December 3, 2007, July 23, 2008 and October 27, 2008. Magnitskiy also gave three formal witness statements to the Russian authorities detailing the fraud against the Russian government and demonstrating how it was possible only with the documents seized by the Moscow Interior Ministry during its office raids. In particular he highlighted the involvement of Interior Ministry Lieutenant Colonel Artem Kuznetsov who had led the raids. Six weeks after giving his last statement to the authorities, in the early morning hours of November 24, 2008, Interior Ministry officers raided Magnitskiy's home and arrested him. He has since been transferred to Matrosskaya Tishina detention facility, where more than six months later his case still has not been brought to trial. At a hearing in Moscow on June 15, 2009, Magnitskiy's detention was further extended until September 15, 2009, and he has been refused bail. Lieutenant Colonel Kuznetsov, implicated in witness statements by Magnitskiy, has been assigned to the Interior Ministry team investigating Magnitskiy's case. Simply put, Magnitskiy is now the Interior Ministry's hostage.

Eduard Khayretdinov, a former judge and now a lawyer in private practice, has been a member of the Moscow City Bar since 1992. Following his retention by HSBC to act on behalf of the Hermitage Fund companies, Khayretdinov filed more than 30 complaints on their behalf setting forth the theft of the Hermitage Fund companies and the fraud against them, questioning the legitimacy of actions taken by law enforcement officials including Lieutenant Colonel Kuznetsov. Shortly after these complaints were filed, Lieutenant Colonel Kuznetsov authorized the opening of a criminal case against Khayretdinov, alleging that he had used a forged power of attorney from HSBC when filing the complaints, despite sworn affidavits from HSBC directors confirming to the court that Khayretdinov was their proper attorney-in-fact.

In a further act of intimidation, a Kazan-based Interior Ministry officer demanded Moscow-based lawyers acting for HSBC, including Khayretdinov and Vladimir Pastukhov, appear for questioning as witnesses in Kazan. This summons violates Russian law (including Articles 23 and 48 of the Russian Constitution, and Article 8 of the Russian Law on Lawyers) which prohibits questioning of lawyers regarding details of cases to which they provide legal assistance. Moreover, they constitute a breach of the Basic Principles on the Role of Lawyers adopted by the United Nations.

These recent acts of intimidation against our lawyers underscore the degree to which legal nihilism has now overwhelmed the last vestiges of the rule of law in Russia. Lawyers in Russia now fear for their personal safety due to the attacks and harassment they will face in

the normal course of representing clients. Being a lawyer in Russia is one of the most dangerous jobs in the world, and the experiences of our lawyers – in particular, Sergey Magnitskiy, Eduard Khayretdinov and Vladimir Pastukhov – demonstrate why this is truer now than ever before. These men have been targeted because they had the courage to speak out against corrupt Interior Ministry officers without whose complicity it would have been impossible to carry out a massive fraud against the Russian government.

### **Implications for U.S. Policy**

While this story of official corruption may sound completely unbelievable, it is unfortunately not unusual in modern Russia. The theft of companies via these tactics (office raids, forgery, false contracts, fraudulent court judgments, attachment orders) has become so common that those who perpetrate these frauds are now known in the Russian vernacular as simply “raiders.” Every day small businessmen, landowners and even large Russian companies are the targets of raiders, and the problem has become so endemic that President Medvedev specifically referred to it in a speech in February 2008, calling for “real instruments to prevent raider activity.” In this case, raiders have taken this problem to a new and absurd extreme by “raiding” the Russian state itself and so far getting away with it.

How should the U.S. government react to this?

**Understand the Nature of the Russian State.** The United States needs to recognize that Russia is not a functioning state as we understand it here in the West. Too often, the corridors of power in Russia are populated by individuals who wear the uniform or have the title of a public official, but who in fact pursue private interests by criminal means. As a result, the decisions of the Russian government are not made with the same interests or considerations as the United States. The United States should not rely on the “good will” of the Russian government or trust that diplomacy as practiced between civilized nations will be effective in dealing with Russia.

**Recognize Russian Interests.** The Russian leadership has repeatedly stated its desire to be treated as an equal by the United States. Furthermore, influential Russian businessmen and government officials covet their ability to access the West and the privileges their wealth and power can obtain here. U.S. policy should be to deny access to the West to any member of the Russian government or business community whom it suspects of corruption or organized crime. Furthermore, the full arsenal of the U.S. Treasury’s anti-money laundering powers should be brought to bear to ensure the proceeds from Russian organized crime and public corruption do not enter the U.S., and in the instances where such funds are already here, such assets should be seized and frozen.

**Russia Presses “Reset” Before the West Does.** Russia needs to demonstrate a true commitment to fighting corruption and purging its public bureaucracy of criminals before the United States presses the reset button.

**Continuously Emphasize Rule of Law via Individual Cases.** The United States can emphasize the importance of the rule of law by continuously bringing individual cases, such as Hermitage’s – where corrupt government officials are working in league with organized crime – to the attention of the Russian government. While many unpleasant things can

happen in the Russian legal system when the world is not watching, the Russian authorities are much more sensitive when under the scrutiny of their Western partners.

**Uphold and Protect International Law Enforcement Institutions.** Requests for international arrest warrants submitted to Interpol and other international law enforcement bodies by countries such as Russia, where the rule of law is deficient, should be subject to a more rigorous review process and a possible veto before being implemented. The effectiveness of Interpol as a crime-fighting organization should not be compromised by Russian or other officials who may attempt to use its resources to harass and retaliate against their opponents – political, commercial or otherwise.

**Protect Lawyers.** In countries where the law works, lawyers are not imprisoned for defending their clients and for speaking out against police corruption. The United States should insist Russia abide by the United Nations Basic Principles on the Role of Lawyers, ensuring that lawyers are able to conduct their work without government interference or political persecution.