

# The Threat of Russian Criminal Money: Reassessing EU Anti-Money Laundering Policy

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## List of Abbreviations

AML- Anti-Money Laundering
EAW- European Arrest Warrant
EBA- European Banking Agency
ESA- European Supervisory Authority
EU- European Union
FATF- Financial Action Task Force
FI- Financial Institution
FIU- Financial Intelligence Unit
FSA- Financial Service Authority (UK)
FSB- Russian Federal Security Service
JIT- Joint Investigation Team
MVD- Russian Ministry of Internal Affairs
NFI- Non-financial institution
OLAF- European Anti-Fraud Office
OOCRP- Organized Crime and Corruption Reporting Project
PEP- Politically exposed person
RBA- Risk Based Analysis
ROC- Russian Organized Crime
RZB- Raiffeisen Zentral Bank
SAR- Suspicious Activity Report
STR- Suspicious transaction report
UNDP- United Nations Development Program
USAID- United States Agency for International Development

## Executive Summary

Since the early 1990s, Russian criminal networks have plagued the European Union. The spread of organized crime groups from Russia, following the break-up of the Soviet Union, has brought with it increased violence and the rise of illicit networks. However, these organized crime groups thrive precisely because the Eastern European member states of the EU continue to allow the illicit money from these groups to pass through their financial institutions. Whether this is because of corruption or an institutional inability to counteract the problem, money laundering persists, which acts to undermine the EU as a whole.

In 2005, the EU adopted the Third EU Anti-Money Laundering (AML) Directive, which saw the ushering in of the new risk-based AML regulation strategy. The system has been lauded as a vast improvement to the bureaucratic and inflexible rule-based system utilized before. Nonetheless, eight years later it is necessary to assess the success and failures of the current system, and identify the need for increased government oversight in countries where money laundering continues to be a problem.

Trends and evidence indicate that there are Eastern European banks actively involved in laundering illegal money from Russia into the rest of Europe. The Baltic States, for example, are often the first port of call for Russian and Ukrainian illicit and stolen capital. Numerous examples illustrate this continuing problem—the Vanagels Connection, for instance, a cross-border money laundering and offshore network that has concealed the origins of millions of illicit euros, has involved numerous Baltic banks. Governments of the Eastern European member states of the EU have begun to counteract money laundering, but their efforts are lethargic and remain mostly unsuccessful.

To combat the continuing spread of money laundering in the EU, three steps must be taken. First, EU banks must do their part to increase compliance with anti-money laundering protocols and not engage in relationships with banks suspected of laundering illicit assets. Second, nations must take responsibility for their financial institutions that are harboring illicit funds. Through their financial intelligence units and justice system, they must ensure financial institutions are reporting money laundering cases, and confiscate illicit capital. Third, in order to ensure

both of the former steps, the EU must take an active role in ensuring all EU countries not only comply, but also enforce money laundering laws. How these steps should be carried out will be covered in this paper.

Russian organized crime continues to be a problem in Europe, and their power and reach will continue to grow if their financial channels are not dismantled. It is up to the EU to stop the rot and compel banks and governments to acknowledge that the long-term risk of being involved with the Russian criminal world is too high.

## Introduction

For the past twenty years, the threat of Russian organized crime (ROC) has loomed large on the EU's doorstep. The proceeds from Russian crime and corruption have gravitated toward the shores of the EU financial world, threatening both financial stability and increasing levels of criminality. Safeguards have been put in place to stop this exodus of illicit capital from Russia, but even so, vast amounts of money have infiltrated EU markets. The problem is not so much that Russian organized crime has increased per se, but rather that efforts have, by and large, not succeeded in curtailing the problem.

Notwithstanding, the EU has attempted to stem money laundering, and adopt policies that require financial institutions (FIs) to supply information to national financial intelligence units (FIUs) regarding possible suspicious transactions. In this regard, the 2005 Anti-Money Laundering Directive, adopted by all EU member states, stipulated increased banking regulation and due diligence from FIUs, but with FIs playing an increased role.<sup>1</sup> Indeed, the ultimate goal was to use FIs as the "eyes and ears" of FIUs.

The transnational money laundering schemes in question, however, are highly complex, involving an intricate nexus between governments and organized crime, especially in Russia.<sup>2</sup> The EU is thus faced with a unique threat: a criminal force that enjoys favor with a national government. The paramount example of this is the 2007 Tax Fraud Scheme, involving the laundering of hundreds of millions of dollars from Russia.<sup>3</sup> The case highlights the forged connections between those working as officials in the tax offices, the Russian police force, and the criminal world.<sup>4</sup> Further, the cover-up and lack of government initiative to investigate the scheme suggest political manipulation.

<sup>1</sup> Etay Katz, "Implementation of the Third money Laundering Directive- An Overview," *Law and Financial Markets Review* (2007).

<sup>2</sup> Catherine Belton, "Tax Scam Points to Complicity of Top Russian Officials," *Financial Times*, April 12, 2012.

<sup>3</sup> "Swiss Money Laundering Investigation in the Magnitsky Case Widens with New Requests Sent to Multiple Swiss Financial Institutions and Accounts Frozen," *Law and Order in Russia*, January 9, 2013, accessed January 10, 2013, <http://lawandorderinrussia.org/2013/swiss-money-laundering-investigation-in-the-magnitsky-case-widens-with-new-requests-sent-to-multiple-swiss-financial-institutions-and-accounts-frozen/>.

<sup>4</sup> The following details of the 2007 Russian Tax Fraud Scheme are from the report prepared by Brown Rudnick in London. Neil Micklethwaite, Re: Hermitage Capital

In 2007, Lt. Col Artem Kuznetsov of the Unit Field Officers of the Tax Crimes Division of the Russian Interior Ministry and Major Pavel Karpov reportedly broke into the offices of Hermitage Capital, a Guernsey-based investment group, in order to obtain the documents of two subsidiary companies of Hermitage. Once stolen, the documents were forged and the companies put in the name of Viktor Markelov, a convicted criminal who had been involved with Kuznetsov and Karpov in a kidnapping a few years earlier. Thereafter, the shell companies, under the control of the Kluyev crime ring, sued the subsidiaries for breach of forged contracts. The contracts between these shell companies and the subsidiaries did not actually exist, and in court the subsidiary companies employed lawyers not connected with Hermitage for the defense. These lawyers raised no defense and accepted the full liability for the claims being brought against the subsidiaries. This was all a calculated charade, and the losses from the claimants offset previous profits of the subsidiaries. By erasing the profits, the subsidiaries were then allowed to apply for tax refunds worth 5.4 billion rubles, which the Russian Tax Offices granted immediately at the end of December 2007. The tax officers involved were given a share of the profits for allocating the money. The profits were forwarded to Universal Savings bank accounts that had been opened two weeks earlier. This money was then dispersed to those involved in the scheme through various banks in Eastern Europe and the UK. The money was eventually used to buy property and real estate in Dubai. Olga Stepanova and her husband, one of the directors of the Tax Office, allegedly laundered their gains through Credit Suisse and transferred it to offshore companies that the couple owned.<sup>5</sup>

Official corruption within the Russian government continued when Hermitage demanded investigation into the scheme. The investigator mistook Kuznetsov's role, and as an employee of the Internal Ministry he was recruited as part of the investigation, so in effect he was investigating himself.<sup>6</sup> Kuznetsov used his position in the investigation to accuse Sergei

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Management Limited/Notice of Suspected Money Laundering and Request for Criminal Investigation in Respect of the Violations of Latvian Laws on Prevention and Combating Money Laundering and Terrorism Finance Request for Criminal Investigation and for Issuance of Asset Freeze Order for Violations of Latvian Laws on Prevention and Combating Money Laundering and Terrorism Finance (London: Brown Rudnick, 2012).

<sup>5</sup> "Swiss Money Laundering Investigation in the Magnitsky Case Widens," *Law and Order in Russia*.

<sup>6</sup> "Lieutenant Colonel Artem Kuznetsov," Website of Stop the Untouchables. Justice

Magnitsky, a lawyer for Hermitage, of involvement in the scheme, placing him in custody and charging him with fraud. Further, Markelov was accused of stealing the documents and was detained, which proved a convenient cover-up since he already had a criminal record.<sup>7</sup> Magnitsky eventually died in jail, prompting a large investigation by Western non-profits.

Within the EU itself, the details of the case are troubling. The exodus of the ill-gotten gains from Russia is suspicious, involving banks in Moldova, Latvia, and the UK.<sup>8</sup> Further, the delay in any sort of investigation by national governments is also of concern. While Hermitage has requested investigations to be carried out by the countries where the money passed through, there has until recently been reluctance to carry them out.<sup>9</sup>

This raises concerning questions regarding not only bank involvement, but also the unwillingness of governments to carry out the laws of the EU Directive. The answers to these two questions will be assessed throughout this report, concluding that a federal EU body must be created to ensure that governments are *enforcing* the new EU laws.

The 2007 Tax Fraud Scheme case, and others, illustrate that the threat of Russian organized crime has not diminished, and the allowance of illicit capital only brings the problem to the EU's shores. This increases both criminal presence within the EU as well as placing financial institutions at risk long-term.

Some eight years have elapsed since the 2005 EU Directive and the adoption of a risk-based analysis system across the EU financial system. An assessment of the system is therefore timely, with a particular focus on what risks still remain. The release of the 4<sup>th</sup> Money Laundering Directive later this year has prompted discussion on how the EU can be more effective in stopping money laundering and where weaknesses still exist. It is obvious that the current system is in no way perfect, and changes must be made.

To begin with, the policy solutions must be based on a hierarchy of accountability. At the top of this is the EU. The EU has been averse to ensuring the enforcement of anti-money laundering (AML) laws, primarily

because there is no EU-wide federal agency directly involved in monitoring member states' FIUs. Currently, effectiveness of AML efforts is the individual responsibility of member states. It is, however, in the EU's best interest to begin pressuring governments to continue to put pressure on FIs and their regulation. One weak link within the system is that money is allowed to enter and become layered amongst other EU banks. Banks will always be concerned with their bottom line, so it is up to the government to ensure that there is enough of a risk of being caught for banks not to accept illicit money.

In addition, changes must be made to the current EU regulatory system to ensure that all national governments are implementing the EU Directive. It is not enough to enact laws. Member states must provide evidence that they are also implementing regulation. It is clear that not all governments can be trusted to do this, and the EU itself needs to take charge of its members. In sum, therefore, the answer lies in coordinated action being taken involving various groups, including FIs, national governments, and the EU itself.

The following chapter provides an analysis of the emergence and development of Russian organized crime in the 1990s, as well as the early efforts to counteract its infiltration into the EU. Chapter Three will look at Russian organized crime in the 2000s, and the major money laundering schemes involving the EU. Chapter Four gives an overview of how money enters the EU, taking an internal perspective to identify the weaknesses of the current system. Finally, in Chapter Five, policy suggestions are outlined on how to combat money laundering in the EU, reviewing also the consequences if concerted efforts are not made.

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for Sergei Magnitsky. 2010, accessed September 14, 2012, <http://russian-untouchables.com/eng/artem-kuznetsov/#importantdates>.

<sup>7</sup> Philip Aldrick, "Fall Guy in Russian Fraud Uncovered by Sergei Magnitsky Paid \$2.1m," *The Daily Telegraph*, April 5, 2011.

<sup>8</sup> Micklethwaite, "Re: Hermitage Capital Management Limited/Notice of Suspected Money Laundering and Request for Criminal Investigation."

<sup>9</sup> Aleks Tapinsh, "Latvia to Check for Bank Links with Magnitsky Case," *Reuters*, October 3, 2012.

## Emergence of Russian Organized Crime in the 1990s

Before engaging in the problem of money laundering from Russia, it is essential to examine the formation of Russian organized crime (ROC) from the 1990s onward. The problem grew immensely after the fall of the Soviet Union, and the weakness of the Russian state provided the foundations for the success of ROC.<sup>10</sup> In the 1990s, the United States and the EU began to recognize the problem of ROC, and the threats that it posed not only to Russia, but to the West's interests as well.

This brief overview will show that the problem of ROC is not new, and that it has persisted and developed for over twenty years. This, in itself, is unacceptable. Looking into the work of Louise Shelley, we will review the EU and U.S.'s efforts to counteract the problem, and the reasons for failure. These efforts will provide context for a review of policies in the 2000s, and reveal that similar problems persist due to a lack of cooperation amongst all parties.

### The State of Russian Crime in the Early 1990s

Organized crime was able to gain a foothold within Russia, according to Dr. Margaret Beare, because the "rapid pace of economic change had increasingly outpaced the legislative efforts."<sup>11</sup> In other words, a legal vacuum formed following the fall of the Soviet Union, which the new Russian government failed to fill. Privatization laws were lacking, and the "basic commercial and capital markets laws didn't exist when voucher privatization was completed in 1994 ... neither did basic institutions to enforce good behavior."<sup>12</sup> What resulted was a system where capitalists were privileged with a dearth of regulations. As a result, organized crime was given almost free reign, a continuation from the late Gorbachev period.<sup>13</sup>

<sup>10</sup> "Organized Crime in the USSR: Its Growth and Impact" (Central Intelligence Agency, 1991).

<sup>11</sup> Margaret Beare, *Russian Organized Crime Around the Globe*. (The Nathanson Centre for the study of Organized Crime and Corruption, 2000), 2.

<sup>12</sup> Bernard Black, Reinier Kraakman, and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?" (William Davidson Institute at University of Michigan Business School, 1999), 26.

<sup>13</sup> "Organized Crime in the USSR: Its Growth and Impact."

These criminals did not emerge from nowhere, and unclassified U.S. Central Intelligence Agency reports reveal that there was a fairly large organized crime presence in the Soviet Union.<sup>14</sup> The organized crime networks were mostly embedded in the pervasive black market. As the Soviet Union became more corrupt in the Brezhnev era, organized crime became more widespread, accepting truces with the Soviet government.<sup>15</sup> Because of the tight state secrecy, the relationship was generally hidden. However, as Gorbachev began to liberalize the Soviet economy, allowing for private enterprise, the organized crime groups moved from the black to the legitimate market.

Arguably, the Soviet organized crime groups were more hierarchical, emerging from the Soviet prisons.<sup>16</sup> The concept of thieves-in-law developed at this time: mafia kingpins, who ran organized crime networks. While the godfather concept does not totally equate to ROC, the system was much more hierarchical in the early 1990s than it would be in the 2000s. Professor Mark Galeotti notes that this first generation of criminal groups was known as the "gulag school," whose presence persisted through the early 1990s.<sup>17</sup>

The hierarchy system could function because the mafia created the law. While in the 2000s, organized crime networks were driven underground. According to then Senator John Kerry, in the 1990s, "the real power [lay] with the Russian Godfather and their allies- former KGB officials with important positions in the sectors of the economy, whether privatized or still under state control, and corrupt politicians in high offices."<sup>18</sup>

Kerry emphasizes the alliance that formed between the Russian officials and organized crime. With the collapse of the state, many lost their jobs, including KGB and military officers, who joined forces with the increasingly powerful crime groups.<sup>19</sup> Even those with jobs were not making enough, and contributed to the rise of organized crime. Corruption was rampant, and in the early 1990s, the organized crime groups gained power over government officials, who were willing to sell their services to supplement their pay.

<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

<sup>16</sup> Mark Galeotti, "Transnational Aspects of Russian Organized Crime" (Chatham House, 2012).

<sup>17</sup> Galeotti, "Transnational Aspects of Russian Organized Crime."

<sup>18</sup> Global Organized Crime Project, "Russian Organized Crime" (1997), [http://www.russianlaw.org/roc\\_csis.pdf](http://www.russianlaw.org/roc_csis.pdf), 3.

<sup>19</sup> Graham Turbiville, "Mafia in Uniform: The Criminalization of the Russian Armed Forces," (Foreign Military Studies Office: United States Department of Defense, 1995).

What is striking about ROC in the early 1990s was its ability to infiltrate almost every sector of Russia, not only in the economy, but in the government as well.<sup>20</sup> According to Yakov Gilinsky, law professor at the St. Petersburg Academy of the Prosecutor-General's Office, organized crime in Russia was built on the following: corrupted power and law enforcement, and the aspiration to create monopolization of territory (and property).<sup>21</sup>

ROC was able to take over the major cities of Russia, placing special emphasis on controlling St. Petersburg and Moscow.<sup>22</sup> In order to gain control of businesses in major cities, the organized crime groups set up protection systems to defend their interests and create criminal spheres of influence.<sup>23</sup> Various organized crime groups were at war with each other, and by providing protection to businesses, they gained the loyalty of the local constituency. According to analysts at the CATO Institute, a United States think-tank, this was the result of the inability of the government to enforce contracts—“Russia's private businesses [were] plagued by the inability to legally enforce businesses contracts, laws [were] often conflicting, and police departments [could not] be relied upon to provide protection from physical threats.”<sup>24</sup>

This protectionist system was the result of a poorly equipped, corrupted police department, and the lack of a clear rule of law.<sup>25</sup> Even by the late 1990s, after Yeltsin attempted to expand the police force, “officials of law enforcement and security services provided criminals with protection from arrest and prosecutions.”<sup>26</sup> By the end of the 1990s, the police and justice department was completely under the thumb of organized crime groups and their allies.

ROC's infiltration of the government was a major step in their *legitimization* in the 1990s. Throughout the decade, the nexus between politicians and organized crime increased.<sup>27</sup> John Deutch, former Director of the CIA, contended in the mid-1990s that “corrupt officials [supplied]

<sup>20</sup> Louise Shelley, “Post-Soviet Organized Crime: Implications for Economic, Social and Political Development,” *Demokratizatsiya* 2 (1994): 341.

<sup>21</sup> Yakov Gilinsky, “Crime and Deviance: State from Russia” (St. Petersburg, 2000). 99.

<sup>22</sup> Shelley, “Post-Soviet Organized Crime,” 346.

<sup>23</sup> Beare, “Russian Organized Crime around the Globe.”

<sup>24</sup> Aaron Lukas and Gary Dempsey, “Mafia Capitalism or Red Legacy in Russia?” (CATO Institute, 2000).

<sup>25</sup> Stephen Handelman, “The Russian ‘Mafiya,’” (Foreign Affairs- Council on Foreign Relations, 1994): 89.

<sup>26</sup> Global Organized Crime Project, “Russian Organized Crime,” 6.

<sup>27</sup> Shelley, “Post-Soviet Organized Crime,” 341.

the crime syndicate with export licenses, customs clearances, tax exemptions and government contracts.”<sup>28</sup> The connections to the government, and the privileges that they garnered, became more apparent throughout the 1990s. By 1997, criminals were purchasing positions and representatives' aids in the Duma for US\$4-5000, allowing ROC to influence any decision that attempted to clean up crime and corruption.<sup>29</sup> By the end of the 1990s, the alliance with the oligarchs in the strategic economic areas gave organized crime groups more power within the government, aiding the illegal and corrupt selling of Russia's resources abroad.<sup>30</sup> ROC groups smuggled oil, gas, and other strategic resources for the oligarchs, avoiding the export tax, and stealing billions of dollars from Russians.

ROC was also able to infiltrate the banking sector, allowing them to control their flow of money out of the country. According to the CIA, 25 of the largest banks in Russia had direct links to organized crime.<sup>31</sup> The Russian Central Bank itself reported that 71 percent of banks in Moscow committed violations of banking legislation in 1995.<sup>32</sup> Thus, the limited banking laws that existed were continuously violated in order to launder the money out of Russia. However, according to the Global Organized Crime Project, they found that very little attention was being paid to Russian bank fraud in the West.<sup>33</sup> This was because, Russian organized crime expert Louise Shelley argues, “Western institutions benefited enormously from the billions of Russian assets laundered and stored in the West.”<sup>34</sup>

As Gilinsky notes, Russian organized crime had corrupted power and monopolized the territory of Russia by the end of the 1990s. The cities were under the control of organized crime networks, and by 1997, a year before the economic collapse, roughly two-thirds of Russia's economy was under the yoke of crime organizations.<sup>35</sup> The warring interests of the crime groups, fighting amongst themselves to build spheres of influence, brought the problem to the streets. The absence of the rule of law, the corruption and inepti-

<sup>28</sup> Global Organized Crime Project, “Russian Organized Crime,” 6.

<sup>29</sup> Handelman, “The Russian ‘Mafiya.’”

<sup>30</sup> Global Organized Crime Project, “Russian Organized Crime,” 6.

<sup>31</sup> Global Organized Crime Project, “Russian Organized Crime,” 39.

<sup>32</sup> Ibid.

<sup>33</sup> Global Organized Crime Project, “Russian Organized Crime,” 6.

<sup>34</sup> Louise Shelley, “Transnational Crime: The Case of Russian Organized Crime and the Role of International Cooperation in Law Enforcement,” *Demokratizatsiya* (2002): 51.

<sup>35</sup> Global Organized Crime Project, “Russian Organized Crime,” 2.

tude of the police, and the growing power of the organized crime groups turned Russia into what many in the Western media termed as the 'Wild West.' In 1992, three out of four Muscovites were afraid to walk the streets at night for fear of organized crime violence as a result of turf wars.<sup>36</sup> Normal Russians suffered not only in the streets: tax evasion and fraud amongst the politicians and oligarchs depleted the country's treasury, depriving Russians of much needed welfare and infrastructural support. Organized crime networks facilitated this problem by transferring the money and resources abroad, and protecting the corrupt officials' ill-gotten capital. According to a 1996 report, 30-50 percent of ROC's revenues returned to corrupt officials.<sup>37</sup>

### ROC's Push Abroad

By the mid-1990s, the West began to recognize the growing threat of ROC. The West felt it was facing an adversary from a country whose government had no control of the problem. Indeed, skepticism of Russia's ability to stem the tide of organized crime's push abroad concerned leaders in the EU, U.S., and Canada.<sup>38</sup>

There were multiple threats posed by ROC, especially in Europe. Arms smuggling was the most concerning for the military, in particular the prospect of nuclear weapons smuggling.<sup>39</sup> Russia's military, like the rest of the country, had fallen to organized crime. The thousands of nuclear weapons could potentially be sold to organized crime groups, and then resold to terrorists or rogue nations.

The second threat concerned the geopolitical situation in Eastern Europe. The West saw Eastern Europe as the bastion of change. Despite Russia's inability to create a steady democracy, the hope still remained that the rest of Eastern Europe would develop successful democracies. ROC could take advantage of the nascent law enforcement and judicial system, stifling democratic development and transparency. The fear was tied to the fact that "Europe had become open in terms of criminal geogra-

<sup>36</sup> Handelman, "The Russian 'Mafiya,'" 94.

<sup>37</sup> Samuel D. Porteous, "The Threat of Transnational Crime: An Intelligence Perspective," (1996), accessed October 15, 2012, <http://www.opensourceintelligence.eu/ric/doc/The%20threat%20from%20transnational%20crime.pdf>. 4.

<sup>38</sup> Beare, "Russian Organized Crime around the Globe."

<sup>39</sup> Turbiville, "Mafia in Uniform."

phy," an added threat to the rest of Europe.<sup>40</sup> Thus, Western governments saw it as imperative that ROC be countered and controlled before it inflicted large amounts of damage on the weak, burgeoning democracies.

The major problem was that "ROC groups had shown an eagerness to pursue criminal activities regardless of political boundaries that might be crossed."<sup>41</sup> What this meant was a swift and broad global expansion of ROC. Organized groups began allying with the Columbian drug trade and the Italian Mafia.<sup>42</sup> The more embroiled ROC became with other organized crime groups, the more difficult it was to counteract the threat. There was hardly a global crime group that the Russians did not partner with—for example, assisting the Cosa Nostra's prostitution and gambling rings, and supplying a Russian-built submarine to the Columbian cocaine smugglers in Miami.<sup>43</sup>

What was more concerning were the increased interactions with legitimate businesses and financial institutions in the West. However, not all parties recognized the fact that money was actively being laundered into the West. According to Louise Shelley, "the discourse on the spread of the Russian mafia [had] obscured the fact that there was Western complicity in Russian organized crime."<sup>44</sup> Billions of dollars were being laundered out of Russia through compliant banks in Western Europe and the United States. While the Department of Justice in the U.S. wanted to protect its banks from Russian illicit assets, these banks themselves had already joined in the schemes. Dr. Margaret Beare noted that in the Bank of New York money laundering scandal, "the financial community (including the media establishment)... objected to the hysteria over 'laundering' because in fact they had benefited greatly from these billions of dollars that had entered the US system, even if for a short period of time."<sup>45</sup> The government, thus, had to counteract their businesses and financial institutions that were aiding and abetting the problem. As we shall see in the 2000s, banks and businesses generally want to make a profit. Thus, Western government crackdown depended on enforcement from the Russians and at home.

<sup>40</sup> Global Organized Crime Project, "Russian Organized Crime," 42.

<sup>41</sup> Global Organized Crime Project, "Russian Organized Crime," 43.

<sup>42</sup> Handelman, "The Russian 'Mafiya,'" 95.

<sup>43</sup> Juanita Darling, "Submarine Links Colombian Drug Traffickers with Russian Mafia," *Los Angeles Times*, November 10, 2000.

<sup>44</sup> Shelley, "Transnational Crime," 51.

<sup>45</sup> Beare, "Russian Organized Crime around the Globe," 8.

### Cracking Down: EU and U.S. Efforts Against ROC in the 1990s

By the mid-1990s, the question centered on what to do about the threat of organized crime stemming from Russia. Cooperation was needed, but as the U.S. Justice Department and constituency within Europe realized, the problem was hard to tackle when the Russians themselves did not have a handle on it. For the most part, by the mid-1990s, Russia's law and judicial departments were under the yoke of ROC.

Louise Shelley has extensively covered what cooperation existed between Russia and the West regarding ROC. She has outlined some of the major challenges of cooperation, from both the investigation and prosecution sides. Her research is based on extensive interviews with individuals in Russia and in the West. The inability for investigations to be carried out depended both on the political will within Russia and the legal framework that was set up during the 1990s. While the U.S. created a mutual legal assistance agreement with Russia, the agreement itself did not guarantee assistance in obtaining evidence.<sup>46</sup> Shelley notes that Western investigations into Russian crime failed due to delays in requests and all out Russian refusal to provide evidence. Politics and corruption often undermined the efforts.<sup>47</sup> Further, successful cooperation was often dependent on good relations between the Russian government and the West. Because of this inconsistency, the FBI attempted to use separate, often unofficial, channels in order to obtain information.

However, as organized crime groups increasingly encroached on Russian politics, they also became involved in investigations, using their influence to "initiate international criminal investigations to get at political enemies or to get members of ethnic minorities involved in crime."<sup>48</sup> In other words, they diverted investigations, providing false clues and evidence. Western investigators, in some cases, were oblivious to this fact, and, for example, the "Dutch law enforcement in the 1990s, [were] unaware of the sophistication of the Russia mafia, did not even consider that they were being exploited by foreign criminals."<sup>49</sup>

<sup>46</sup> Shelley, "Transnational Crime," 51; Richard L. Palmer, "Statement on the Infiltration of the Western Financial System by elements of Russian Organized Crime" (House Committee on Banking and Financial Services, 1999).

<sup>47</sup> Ibid.

<sup>48</sup> Shelley, "Transnational Crime," 56.

<sup>49</sup> Ibid.

Thus, increasingly, Western law enforcement realized that the information and intelligence supplied by the Russians was false or contradictory.

Similar problems were encountered at the prosecution level. Telephone justice, already common in Russia, also influenced efforts abroad.<sup>50</sup> Oligarchs and corrupt officials manipulated the Prosecutor General's Office in order to protect ROC constituents and allies.<sup>51</sup> However, the Russians were mostly compliant with international investigations and cases when it involved non-Russians, and issues of morality, such as sex tourism and child pornography.<sup>52</sup>

The efforts of the West concerning ROC were for the most part unsuccessful. Despite their energies, the increasing corruption of the Russian police, Interior Ministry, and General Prosecutor's Office made procurement of evidence and successful investigations exceedingly difficult. The FBI occasionally was able to obtain evidence through informal channels, but this evidence did not hold up in court. As we shall see, the same problems persist today, but in a different guise.

### Conclusion

Organized crime in Russia flourished during the 1990s. From its roots in the Soviet Union, ROC thrived on the lack of rule of law in Russia. The insistence on privatization before ironing out the legal framework was a blessing to the ROC groups, who prospered from the unbridled capitalism. They were able to expand into every part of society, creating a neo-Wild West. Capitalizing on corrupt politics, ROC gained a foothold within the government to better ensure that their free reign would continue.

With their success in Russia, ROC groups expanded abroad. Blessed with protection from the Russian state, including a lack of extradition laws, corrupt police, and control of the Interior Ministry, ROC allied with almost every major organized crime group in the world. While ROC gained unprecedented power in the 1990s, Putin's election in 2000 put their interests at risk. However, ROC would not disappear, and under Putin's "rule of law," they would adapt, and remain a powerful force.

<sup>50</sup> Robert Amsterdam and Alena Ledeneva, "Russian Perspectives on International and National Law - Meeting Summary" (Chatham House: 2010), 5.

<sup>51</sup> Shelley, "Transnational Crime," 58.

<sup>52</sup> Ibid., 59.

## Change and Continuity: Russian Organized Crime in the 2000s

Organized crime remains in Russia despite the major political change in 2000. While Putin has ushered in a “rule of law,” which was almost non-existent in the 1990s, Russian criminals have adapted and changed to reflect the shifting political situation. The result is an increasingly transnational crime network, which thrives because of its overall furtive reach both in Russia and abroad. The Russian organized crime (ROC) networks are highly malleable, their presence discreet and layered within the international financial and business sectors.

ROC’s change from the 1990s is based on a structural realignment. A major difference between ROC in the 2000s, and most other organized criminal networks, is that a formal hierarchy does not exist.<sup>53</sup> The thieves-in-laws<sup>54</sup> presence has dwindled, and the group is able to function without an overall kingpin.<sup>55</sup> This is what makes ROC so challenging to fight. Unlike the Italian mafia system, ROC is made up of cell-type criminal groups, based on informal, but effective, alliances: the power of which should not be underestimated.

One of the major distinctions that must be made is ROC within Russia, and ROC operating within the rest of the Europe. ROC is a transnational force, relying on a well-maintained and streamlined system that funnels illicit capital into the EU. How this money originates, the easy exodus out of Russia, and why criminals want to move it out of Russia are all important questions considered in this chapter.

### Political Nexus: The Continued Lifeblood of ROC

By the second half of the 1990s, ROC persisted because the most prominent members of the government, the oligarchs, sanctioned and supported its presence. The relationship licensed “a closer interaction between representatives of public authorities and those of the criminal world ... more and more cases of corruption occurred as well as cases

involving public officials in fraudulent schemes.”<sup>56</sup> Those in the corridors of power embroiled themselves in organized crime, establishing a strong nexus between these two camps. Illicit money moved easily through banks, which, for the most part, the oligarchs controlled.<sup>57</sup>

Putin’s advent jolted the criminal world. There was a growing fear among the criminals that Putin’s proposed rule of law would spell an end to their state protection. However, the nexus remained, but in a different guise. The new relationship with the Kremlin was not based on outright support, but a subtle and menacing alliance that continues today.

Putin’s control of organized crime is unique. According to a senior member of the Russian police, the relationship between ROC and the government is based on the premise that they can operate as long as they cooperate with the government and do not meddle in its functioning. Their operations must be within the confines of rules set by the Kremlin. ROC no longer makes the rules, but instead exists as an entity within Putin’s power system.<sup>58</sup>

While the allowance of organized crime intrinsically contradicts the goal of increased rule of law, the relationship within Russia is much more subtle than many have suggested. Deeming Russia simply a mafia-state fails to reflect the complexity of the nexus between the government and organized crime. From a strategic point of view, Putin’s actions make sense. In the early 2000s, Russia was still recovering internally from the 1998 economic crash. While the economy was improving, instability was rife. Gas and oil prices had not reached the level of the mid-2000s, and Putin’s authority had not yet reached its pinnacle. With instability palatable, Putin wanted to avoid a war between the government and the mafia, if possible. Crackdown of such a formidable force risked serious conflict, and more importantly would alienate a powerful ally of the oligarchs. In 2000, Putin was intent on removing the oligarchs from political power.<sup>59</sup> Waging all-out war on both the oli-

<sup>56</sup> Walter Kegö and Alexandru Molcean, “Russian Speaking Organized Crime Groups in the EU” (Stockholm: Institute for Security and Development Policy, 2011), 16.

<sup>57</sup> R.G. Gidadhubli and Rama Samptkumar, “Putin’s Confrontation with Oligarchs,” *Economic and Political Weekly* 3 (2000).

<sup>58</sup> Charles Clover, “Who Runs Russia?” *Financial Times*, December 16, 2011.

<sup>59</sup> Marshall Goldman, “Putin and the Oligarchs,” *Foreign Affairs* 83 (2004): 36; Putin was quoted as saying “those people who fuse power and capital: there will be no oligarchs of this kind as a class,” Gidadhubli and Samptkumar, “Putin’s Confrontation with Oligarchs.”

<sup>53</sup> Galeotti, “Transnational Aspects of Russian Organized Crime.”

<sup>54</sup> Mafia kingpins, who ran organized crime networks

<sup>55</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012.

garchs and mafia would be difficult. Offering ROC a “secret” olive branch granted him security politically and on the streets, certifying his rule of law.

Outwardly he waged a pseudo-war on the ROC, cracking down on their interests and financial assets, imposing a dictatorship of law.<sup>60</sup> However, Putin consolidated his relationship with ROC groups through rules and limitations that ended up benefiting both. The rules were based, for the most part, on the premise that if ROC groups did not encroach on Putin’s interests, he would allow them to continue to operate.<sup>61</sup> This meant dissolving their alliances with the oligarchs, ending their outright control of the streets, and limiting their allegiances with members of the Duma and regional governments. The extent of these rules is not entirely known, being shrouded in official secrecy and an absence of codification.

### Rules of the ROC Game

The best way to access these rules is studying the cases where they have been broken. These cases reveal the complexity of the nexus, but also the price for failing to fulfill the bargain. The first case, involves the Tombov Gang, a major ROC group functioning within Russia. This case reflects an apparent breach of criminal authority into an off-limits strategic area. According to intelligence procured by Stratfor and released by Wikileaks, the so-called head of the Tombov gang, Vladimir Barsukov, had attempted to move into the oil industry in St. Petersburg. Barsukov was subsequently arrested and charged with extortion in March 2012.<sup>62</sup> Barsukov’s attempt to move into the strategic oil industry has been denied by Moscow, but the intelligence and the subsequent prosecution of Barsukov falls in line within Putin’s rules: ROC must not attempt to gain control of strategic areas, such as oil, gas, and defense.

The case of Yury Luzhkov, the former Mayor of Moscow, provides insight into the fall from grace of a major political figure with ties to organized crime. While he is not a criminal kingpin himself, both Western and

<sup>60</sup> Vsevolod Sokolov, “From Guns to Briefcases: The Evolution of Russian Organised Crime,” *World Policy Journal* 21 (2004): 71.

<sup>61</sup> William Partlett, “Putin’s Artful Jurisprudence,” *The National Interest*, January 2, 2013.

<sup>62</sup> “Gangster Who ‘Crossed Putin’s Allies’ Jailed,” *Ria Novosti*, March 5, 2009, <http://en.rian.ru/crime/20120306/171795700.html>.

Russian sources confirm his connections to the criminal underground.<sup>63</sup> Wikileaks has confirmed many people’s suspicions regarding Luzhkov’s connections to ROC.<sup>64</sup> The Russian news sources, on the other hand, tried to pin Luzhkov as a solitary character within the government. They concentrated less on his connections and more on the allowance of corruption.

Instead of waging war on ROC, by acting as their chief (by means of the FSB and MVD) Luzhkov was able to situate himself at the top of the criminal hierarchy.<sup>65</sup> His connections with Semion Mogilevich, one of the world’s most dangerous criminals, are cited, including the fact that Mogilevich’s companies were under Luzhkov’s political watch.<sup>66</sup> Though the source was Boris Berezovsky, an enemy of Luzhkov, information disseminated by Wikileaks supports this possibility.<sup>67</sup> Western intelligence sources see these connections as necessary for Luzhkov to control Moscow.<sup>68</sup> This pattern follows the overall Kremlin strategy: ally with the underworld to keep order. But, this search for stability should not distract from the Western evidence of collaboration between Luzhkov and the ROC in the form of money laundering and official corruption. The Russians and the West cite Luzhkov’s construction projects, whose sole purpose was to cover up laundered money, likely to be from dealings with the ROC.<sup>69</sup>

Luzhkov’s fall from power is linked to the fact that his politics had been at odds with the Kremlin’s for some time, including criticism of Medvedev and the ruling elite’s strategies.<sup>70</sup> Further, some believe that

<sup>63</sup> Ross Osermann, “The Battle for Moscow’s Billions: Power and Money in the Russian Capital under Mayor Sergei Sobyenin” (Wilson Center, 2011).

<sup>64</sup> Luke Harding, “WikiLeaks cables: Moscow Mayor presided over ‘pyramid of corruption,’” *The Guardian*, December 1, 2010.

<sup>65</sup> Ibid.

<sup>66</sup> “In by Nine, Out by Five...,” *The Jamestown Foundation*, August 30, 1999, accessed January 12, 2013, [http://www.jamestown.org/single/?no\\_cache=1&tx\\_ttnews%5Btt\\_news%5D=25717#.UcouY2TSPNA](http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=25717#.UcouY2TSPNA); Palash Ghosh, “The World’s Most Powerful Mobster That You’ve Probably Never Heard Of,” *International Business Times*, December 30, 2012.

<sup>67</sup> “Moscow- Luzhkov and the ‘Other Mafia,’” Wikileaks, accessed September 19, 2012, <http://inmoscowshadows.wordpress.com/2010/12/03/wikileaks-3-moscow-luzhkov-and-the-other-mafia/>.

<sup>68</sup> Osermann, “The Battle for Moscow’s Billions.”

<sup>69</sup> Joshua Keating, “The Luzhkov Dilemma,” December 1, 2010, accessed January 2, 2013, [http://wikileaks.foreignpolicy.com/posts/2010/12/01/the\\_luzhkov\\_dilemma](http://wikileaks.foreignpolicy.com/posts/2010/12/01/the_luzhkov_dilemma).

<sup>70</sup> Luke Harding, “Russian President Sacks Moscow Mayor,” *The Guardian*, September 28, 2010; Conor Humphries, “Medvedev Fires Defiant Moscow Mayor,” *Reuters*, September 28, 2010.

he was encroaching on the Kremlin's economic interests.<sup>71</sup> The Kremlin has accused him of corruption and connections to corrupt construction projects for his wife.<sup>72</sup> Such a powerful politician with ties to crime, who was beginning to oppose and threaten the Kremlin, did not fall in line with Putin's rules. Thus, the golden rule of the Kremlin appears to be: do not infringe on the Kremlin's interests when not instructed to do so.

### ROC and the Siloviki

While the golden rule forbids involvement in the Kremlin's interests, the Kremlin uses ROC to advance its own interests when needed. The Luzhkov case also highlights the direct involvement of the Kremlin and Siloviki in organized crime. The relationship is manifested in "close, almost seamless, links with the 'deep state' kleptocracy of government, parliament, civil service, law enforcement and business at all levels, as well as the military and, above all, the security services."<sup>73</sup> Galeotti believes that Putin himself is not directly involved in organized crime, but he uses the force indirectly for his own needs. This includes helping the Kremlin get local United Russia candidates elected, and using ROC to carry out small favors against individuals who are causing problems in the local regions without using the police.<sup>74</sup>

The 2006 assassination of the Deputy Chairman of Russia's Central Bank, Andrei Kozlov, opens up intriguing questions concerning money laundering and connections to the Siloviki and FSB. While Kozlov's murder has been supposedly solved, the banker Alexei Fenkel being charged with the crime,<sup>75</sup> the events in the weeks leading up to the murder provide reason for trepidation about increased official connections to ROC and money laundering.

Natalia Morar and *The New Times* in Russia spearheaded an investigation into the revocation of the license of the Moscow Credit Bank Diskont.<sup>76</sup> Her

<sup>71</sup> Osermann, "The Battle for Moscow's Billions."

<sup>72</sup> "Luzhkov Deputy Expects New Moscow Mayor by end of October," *RIA Novosti*, September 28, 2010.

<sup>73</sup> Evan Grant, "The Russian Mafia and Organized Crime: How can the Global Force Be Tamed," *OpenDemocracy*, October 12, 2012.

<sup>74</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012.

<sup>75</sup> Andrew Kramer, "Banker Sentenced to 19 Years in Murder of Russian Regulator," *The New York Times*, October 13, 2008.

<sup>76</sup> Natalia Morar, "Officials are Taking Money Away to the West," *The New Times*, May 21, 2007.

work came on the heels of receiving an anonymous leak from the Russian Interior Ministry in reaction to criminal case #248089, filed on September 8, 2006, against unidentified persons within Diskont Bank. The leak alleged that these persons were charged with creating front companies for the purpose of laundering money. This incidentally was in conjunction with Kozlov's revocation of Diskont's banking license and the freezing of its assets. Diskont Bank had all the trappings of a pocket bank: very few customers and large dealings in money from offshore companies. Seventeen firms, some close to the Kremlin and FSB, deposited into Diskont bank.<sup>77</sup> According to the anonymous leak, Deputy Director of the FSB, Alexander Bortnikov, allegedly made deposits.<sup>78</sup> The Diskont Bank case suggests that the proceeds from official corruption are being laundered through privately owned banks.

The connections go beyond money laundering, and evidence suggests that the Russian government has used ROC for privateering functions, including weapons smuggling. Jose Grinda, a Spanish prosecutor involved in the prosecution of Russian criminals within Spain, has suggested that Russian military intelligence was involved in supplying Kurdish rebels with smuggled arms through ROC networks.<sup>79</sup> Another suspicious case was the 2009 hijacking of a Russian shipping vessel carrying timber off the coast of Sweden.<sup>80</sup> The whole incident was shrouded in mystery, including the identity of the "pirates." According to an anonymous Russian Navy general involved in the investigation, there could be a link to "possible weapons shipments, in particular S-300 or X-55 missiles bound for Iran, and sold by a 'weapons mafia' involving top Russian officials but operating outside of the law."<sup>81</sup> While conspirators have been major proponents of the alleged connections to the Russian government and organized crime, the general's account gives credence to an unclear international situation.

Both of these cases suggest that a *privateering* relationship exists between the Russian government and the organized crime networks, a relationship that continues to blur the lines between the government,

<sup>77</sup> Ibid.

<sup>78</sup> Ibid.

<sup>79</sup> Moises Naim, "Mafia States," *Foreign Affairs*, May/June 2012.

<sup>80</sup> Ibid.

<sup>81</sup> Shaun Walker, "'Arctic Sea' was Carrying illegal arms, say general," *The Independent*, August 29, 2009, accessed December 17, 2012, <http://www.independent.co.uk/news/world/europe/arctic-sea-was-carrying-illegal-arms-says-general-1778970.html>.

FSB, and organized crime. More concrete evidence is required to ascertain that there is a direct relationship between these groups. However, this is indicative of the entire situation: the alliance is successful because concrete evidence remains elusive. The Russian arms trade is nothing new, and using organized crime rings, seemingly separate from the state, offers an opportunity to supply “dangerous” nations and groups with weapons.

### Ordinary Russians and ROC

The infiltration of ROC is not a new phenomenon in Russia. In comparison to the 1990s, when organized crime impacted the everyday life of Russians, the 2000s have seen a large improvement. In fact, fear regarding organized crime has declined drastically, and very rarely do ordinary citizens experience the outright effects of organized crime. In this regard, violence against regular citizens has diminished, and people do not live in constant fear of attacks on the streets.

This however should not obscure the fact that organized crime continues to facilitate fraud and corruption—directly swindling Russians from tax revenues and capital. The 2007 Russian Tax Fraud Scheme is a good example of the amount of Russian taxpayers’ money being laundered abroad. What is more concerning is that the official connections with ROC still prevail, including in law enforcement.<sup>82</sup> Organized crime remains because corruption in the state exists. As long as officials continue to be involved with organized crime and the alliance remains, ordinary Russians will continue to suffer.

### Push Abroad

One of the major questions concerns why criminals want to move their money abroad, especially considering the Kremlin seems to allow criminal activity. There are three reasons, both based on the fact that Putin’s actions are often unpredictable, and Russian markets remain volatile.

The first reason is security from the unpredictable political climate of Russia. In its current state, ROC is subject to the political whim of the Kremlin. As was seen even in 2000, at the time of Putin’s initial crackdown

<sup>82</sup> Andrew Osborn, “Russian Mafia Buying Jobs in Police and Judiciary,” *The Telegraph*, August 19, 2010.

on the mafia, Putin is not predictable. If, as in the case of Barsukov, the Kremlin decides to attack a ROC group, criminal assets are safer abroad. While Russia is considered a safe haven for illicit money, the Kremlin is increasingly consolidating information on the criminals and their money trails.<sup>83</sup> With this information, the Kremlin can, if it chooses, prosecute criminals with some ease, and confiscate their money. If the money is sent abroad, however, the assets are much more difficult to locate and sequester.

The second reason is that the more countries the money is layered through, the harder it is for law enforcement to identify and confiscate. In the 2007 Russian Tax Fraud Scheme, once the money was received from the Russian tax authorities it was laundered through half-a-dozen Russian banks, and then transferred to Moldova, Cyprus, UK, and the British Virgin Islands.<sup>84</sup> Thus, to trace the money trails, and to implement an effective investigation, investigators need cooperation from multiple countries. Non-EU countries add an extra hurdle to investigations, since investigation and evidence sharing agreements are less likely to exist. Thus, there are two ways to launder illegal money. The first is to buy property, including real estate, cars, boats, and airplanes. Once the money is used to purchase property, it is extremely difficult to track due to weaker regulations on non-financial institutions. The conspirators in the 2007 Tax Fraud Case quickly bought property in the U.A.E. and abroad. Legitimate businesses rarely regulate for money laundering, so buying property is usually easily accomplished, and records can be forged.

The second way to launder money is to first transfer the money through non-EU countries, such as Moldova and Russia, before transferring it to the EU so as to better “legalize” the money. In order to do this, the money must be “washed” so that it looks somewhat legitimate. These channels are characterized by a weak judiciary and banking system, that allows for the money to be easily transferred. If this is done, according to Galeotti, many Western banks will accept the money.<sup>85</sup>

The Katsyv family’s involvement in the laundering of money from Russia into Israeli banks reflects the use of weak international channels, and exposes the route of official money being sent abroad from Russia.

<sup>83</sup> Interview by Alexander Georgieff with William Partlett, December 7, 2012.

<sup>84</sup> Alec Luhn, “Whatever Happened to the Magnitsky Money?” *Global Post*, January 2, 2013, <http://www.globalpost.com/dispatch/news/regions/europe/russia/121213/russia-magnitsky-money-corruption-putin-hermitage-browder>.

<sup>85</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012.

Peter Katsyv and his son Denis Katsyv were charged in Israel in 2005 with laundering money through their Martash Investment accounts in the Israeli Hapoalim Bank. Petr Katsyv, who was the Russian Deputy Minister of Transportation, allegedly laundered, through the company and its bank accounts, 250 million Israeli shekels (about \$64 million) that he skimmed off from the Russian government. Hapoalim Bank allowed for the money to be transferred, and according to Sam Vaknin, there is evidence that Israel has turned a blind eye to the origin of money transferred from South Africa and Russia.<sup>86</sup> According to *Globes*, an Israeli business news source, the Israeli government acquitted the bank officials involved in the scam, saying that the defense materials were not properly handed over.<sup>87</sup> The source reports that in 2010 the judge then argued that the Israeli state's conduct of the case was bad, and impeded a fair trial, and that the defendants acted in accordance with the procedures of the bank and without intention to conceal information. The judge's ruling, while correct pertaining to the evidence, is suspicious concerning the latter point. In 2012, Hapoalim's chairman was indicted on charges of money laundering, reflecting a culture of money laundering that exists within the bank.<sup>88</sup>

Katsyv ended up settling, and Martash Investment signed an agreement with the Israeli government in order to not be indicted for money laundering.<sup>89</sup> In this agreement they were ordered to pay 35 million shekels (about \$8 million).<sup>90</sup> The settlement reflects the overall fear from the Katsyv family of an investigation, which could have led to the source of the money. The main income of the family was revealed to be "supervising" the trucking industry. Indeed, transportation development in Russia is notoriously corrupt.<sup>91</sup> Evidence showed that the money in Israel was intended to be transferred and laundered abroad.<sup>92</sup> By avoiding a trial, the tracks of

the money could more easily be covered and the exposure of corruption at the state level avoided. This could also explain why Russian government-owned news sources have been reluctant to cover the story. Evidence of corruption at the state level in Russia could lead to Petr Katsyv's dismissal.

The Katsyv case reveals concerning trends, including the allowance of money laundering through Israel. Further, Russia's reluctance to report or investigate an official with ties to money laundering is suspicious. This supports the apparent state allowance of illegal activity, and apathy over its internationalization.

### The Internationalization of ROC

ROC networks are extremely fluid and malleable, which allows them to be successful abroad. Because of the lack of hierarchy, the system is based on a network of temporary, but effective, alliances that allow ROC groups to evade law enforcement. ROC groups have been especially adept at forming these alliances within almost every country in Europe.

The internationalization of ROC, as seen with Israel, has been a strategic move in order to better integrate the groups within the legitimate business and financial world. It has also allowed ROC groups to ally and work with other countries' organized crime groups. According to Galeotti, by allying with local crime groups, the Russians are able to keep a lower profile and hide the transnational linkage, which ultimately attracts more attention.<sup>93</sup> Thus, crimes appear to be linked to, for example, Latvian criminals, instead of the Russians.

Russian criminals have built their empire by employing not only foreign criminal groups, but integrating themselves within the legitimate sector. The criminals have gained expert knowledge of the countries they have settled in, employing lawyers, bank officials, and accountants. ROC does not operate through thug gangs, but instead employs mid- to high-level individuals to carry out their business, including "at the highest levels they are able to deal as equals with business chiefs, civil servants and politicians."<sup>94</sup>

Millions," *Izrus*, December 28, 2008, accessed 18 September, 2012, <http://izrus.co.il/oli-garhi/article/2008-12-28/3197.html>.

<sup>93</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012.

<sup>94</sup> Grant, "The Russian Mafia and Organized Crime."

<sup>86</sup> Sam Vaknin, "Money laundering in a Changed World," *United Press International*, November 1, 2001.

<sup>87</sup> Chen Ma'anit, "Judge Throws out Bank Hapoalim Indictments," *Globes*, August 22, 2010.

<sup>88</sup> "Ex-Israeli Bank Chairman Indicted On Suspicion of Fraud, Money Laundering," *The Washington Post*, October 28, 2012.

<sup>89</sup> "Money Laundering in the Hapoalim Bank: One of the Cases Closed for 35 Million," *Israeland*, June 29, 2005.

<sup>90</sup> *Ibid.*

<sup>91</sup> "Laundering of Large Sums of Money Through the Tel Aviv Branch of the Hapoalim Bank," *Pravdoy*, December 10, 2008.

<sup>92</sup> Galina Malamant, "Bank Hapoalim Deal: Russian Oligarchs Who Helped Bleach

According to Galeotti, we are currently experiencing the third generation of Russian criminals.<sup>95</sup> While the first generation was based on the old gulag school, the second being those who bought their way into the system, the third generation “represents the rise of the criminal figure ensconced within the ruling political and economic apparatus.”<sup>96</sup> This generation comes from inside the elite, educated in the West and armed with important connections throughout the EU.

The criminal empire that has emerged is tightly controlled and ingeniously orchestrated—shrouded in secrecy and false identities. The Vanagels Group, an offshore network that specializes in laundering money from fraud and crime, epitomizes the complex networks that have emerged.<sup>97</sup> Centered in the Baltic states, the network encompasses Ukraine, Moldova, Russia, as well as the UK and Cyprus, according to Scalaris, a German intelligence service that specializes in white-collar crime.<sup>98</sup> Scalaris admits that the information on this network is incomplete, but the work of investigative reporters in the region has revealed the extent of the network. This network seems to be a major avenue for illegal profits leaving Eastern Europe. Understanding of this network is vital to investigating money leaving Russia and Ukraine, and has been tied to the 2007 Russian Tax Fraud Scheme, as well as multiple cases involving corruption in the Ukrainian government.<sup>99</sup>

The Vanagels Network can be described as a multinational offshore supermarket enterprise. Two major offshore entities are pivotal to the scheme: International Overseas Service in Riga and Highway Investment Processing LLP. The Organized Crime and Corruption Reporting Project (OCCRP), a conglomerate of news sources in the region, has done extensive work on the scope of the network.<sup>100</sup> They have found that the owners of these companies are Erik Vanagels and Stan Gorin, respectively. Vana-

<sup>95</sup> Galeotti, “Transnational Aspects of Russian Organized Crime.”

<sup>96</sup> Ibid.

<sup>97</sup> “Russian Laundering Machine,” Organized Crime and Corruption Reporting Project, November 22, 2011, accessed September 17, 2012, <http://www.reportingproject.net/proxy/en/russian-laundering-machine>.

<sup>98</sup> Andrea Galli, “Erik Vanagels- The Extent of a Money Laundering Supermarket,” Scalaris, February 23, 2012.

<sup>99</sup> “Russian Laundering Machine,” Organized Crime and Corruption Reporting Project.

<sup>100</sup> Ibid.

gels is a homeless man in Riga, and Stan Gorin is a resident of the country and oblivious to the dealings; thus both are victims of identity theft.

The Vanagels Network utilizes front companies in the UK and Cyprus.<sup>101</sup> Criminal money is forwarded to these front companies, which either transfer the money on to other front companies in the network or to their bank accounts in the Baltics, such as Trasta Komercbank, a legitimate bank in Latvia.<sup>102</sup> These banks, while maintaining they do not allow for money laundering, seem reluctant to do background checks or stop the flow of money. The Network also operates in the other direction, for example in the Chernomorenftgas Case, where \$400 million was paid to the Highway Investment Processing LLP (allegedly owned by Gorin) for drilling equipment for the Ukrainian state-owned oil company Chernomorenftgas.<sup>103</sup> The company won the bid in a no-competition order. In reality the equipment only cost \$248.5m, so \$151.5m was pocketed. The oligarch Yury Boyko, formerly Minister of Fuel and Energy and currently Vice Prime Minister of Ukraine, is a definite suspect.<sup>104</sup>

One of the more notorious front companies in the Vanagels Network is Nomirex, which has been covered extensively by OCCRP. A yoga instructor from Cyprus allegedly owns the company.<sup>105</sup> Meridian Companies House Limited, a legitimate international financial company, registered Nomirex, but has received no information about the company following its set up.<sup>106</sup> A spokesperson for Meridian claimed that anyone can set up a company via the Internet, but this begs the question why companies such as Meridian are doing very little to regulate who they are registering, and why they are not doing more extensive background checks? Nomirex’s network is extensive, and it seems to be a large hub for Russian illegal money. The money entering Nomirex’s bank accounts involve legitimate Russian banks including Sberbank and VTB Bank AG, a subsidiary of a larger German Bank.<sup>107</sup>

The Vanagels Network has developed links to officials within Russia, Ukraine, and other Eastern European countries. The network survives because

<sup>101</sup> Ibid.

<sup>102</sup> Ibid.

<sup>103</sup> Ibid.

<sup>104</sup> Galli, “Erik Vanagels.”

<sup>105</sup> “Russian Laundering Machine,” Organized Crime and Corruption Reporting Project.

<sup>106</sup> Ibid.

<sup>107</sup> Ibid.

the law enforcement allows it to remain. Besides law enforcement and government's apparent reluctance to aid in uncovering some of the major plots, the roots of these organized crime networks are difficult to counteract. Well-maintained and protected international networks allow money to move fast, and stopping these flows requires a very high degree of organization from states.

## Conclusion

ROC has developed since the 1990s, not only adapting to changes within Russia, but in Europe as well. It has become a truly international force. What makes ROC so difficult to combat is that it has leached into the legal sector, hiding amongst legitimate businesses and financial institutions. They have adapted to the laws, and worked to ally with key figures in order to stay above the system.

Within Russia, government support for ROC is not as blatant as it was in the 1990s, but that should not obscure the fact that Putin has control of these groups. Putin keeps them within confines, but nonetheless allows them to operate. He has ensured that they do not rise above the ceiling of power he has set for them. Any attempt is seen as a challenge, and usually ends in a criminal charge or death. Within these confines, however, ROC is able to operate: allying with officials, laundering money out of Russia, and maintaining a presence within the country. As a result, Putin has avoided a large-scale war with organized crime, while keeping the Russian streets safer.

Internationally, ROC continues to thrive. ROC is multinational, which gives it an extra level of security regarding confiscation. Russian criminals continue to send their money abroad, and there is evidence that ROC has been used to carry out fraud as modern privateers: conducting work for the Russian government, while enjoying international protection.

The presence of ROC is a major concern. How do these groups function so successfully abroad, and why have the mechanisms to stop them for the most part failed? These questions will be answered in the following chapter, and make up the crux of this report. As we shall see, blame can be attributed to multiple players.

## The Resilience of EU Money Laundering Networks

The persistence of Russian organized crime (ROC) on the EU border brings with it major issues of financial security and crime. As shown in the previous chapter, ROC has remained, in a similar guise, for over twenty years. Money laundering facilitates the problem. Without the ability to launder proceeds, crime would have difficulty surviving. However, weak links remain that allow illicit money to flow out of Russia. Thus, money laundering is a major issue that must be combated. Who is responsible for the maintenance of these weak links is not completely obvious or clear. Multiple parties should be scrutinized, including international organizations, national governments, and the financial institutions (FIs), to better understand the needed accountability and transparency.

This chapter will specifically look at the role of FIs, EU member states, and the EU itself in the maintenance of a flawed system.<sup>108</sup> The significant degree of money laundering continues not just because of one group or one country. Thus, we will try to convince the reader that it is the compilation of many parties that allows money laundering to persist at this level.

Money laundering in the EU is not a new problem, but with the changes made in 2005, new difficulties have emerged that must be identified and understood. The anti-money laundering (AML) system, especially in small countries, continues to be weak, despite the longstanding nature of the problem.

## Fundamentals of Money Laundering Regulation

Before understanding who is to blame, the contemporary system of regulation must be reviewed. Currently banks are the main tools for the identification of money laundering. This is delineated under the risk-based analysis (RBA) system that every country in the EU adapted after 2005, through the 3<sup>rd</sup> AML Directive. The EU made a fundamental switch to the RBA system following a review of the flawed rule-based system. Unlike

<sup>108</sup> This chapter will focus on why money continues to flow into the EU, so we will ignore international organizations such as the UN and FATF for the time being. However, these organizations will be scrutinized and make up our conclusion of why these weak links remain.

the rule-based system, the RBA system allows financial institutions more freedom in monitoring, since “control effectiveness is a relative measure ... it depends on the level and type of inherent risk you are trying to mitigate and on your risk tolerance—what level of residual risk is acceptable to your organization.”<sup>109</sup> In other words, it accepts that one size does not fit all in terms of regulation, and that banks understand their risks.

The rule-based system, which was widespread throughout Europe before 2007, relied on clear, formal criteria in which the regulator (the government) would determine whether a transaction was suspicious.<sup>110</sup> All bank transactions over a certain amount, usually around 15,000 euros, were reported and forwarded onto the government’s regulatory body.<sup>111</sup> Thus the system was based on enhanced government diligence, but banks played less of a role. There was some automation for unusual activity, but it was in its infancy and prone to error. Thus, as long as money was laundered below the threshold, it was likely to go unnoticed.

There were two fundamental problems with this system. One, money launderers learned to break up their transaction to a value below the threshold, a tactic known as smurfing.<sup>112</sup> Of course, a bank would find it suspicious if the same criminal brought in 8,000 euros every day for two weeks, but criminals devised strategies to circumvent the problem of being noted as suspicious, including using multiple bank branches. However, they relied most strongly on a lack of training amongst bank personnel and the lack of a comprehensive computer transaction monitoring system.

Second, the governments tended to receive a surplus of useless suspicious activity reports (SARs).<sup>113</sup> The banks were required to send information on all transactions over the threshold level, which was not a small amount of information. The banks could very rarely use their own discretion to determine whether an over-the-threshold transaction warranted further investigation, and were required to report

<sup>109</sup> Patrick Ho and Jennifer Fiddian-Green, “AML Compliance: Risk Based Approach” (Grant Thornton LLP, 2012).

<sup>110</sup> Elod Takats, “A Theory of ‘Crying Wolf’: The Economics of Money Laundering Enforcement” (International Monetary Fund, 2007).

<sup>111</sup> “Anti-Money Laundering Guidance for Money Service Businesses” (HM Revenue and Customs, 2010).

<sup>112</sup> Takats, “A Theory of ‘Crying Wolf.’”

<sup>113</sup> *Ibid.*

everything that fitted the criteria. Thus, the government regulators were not only overwhelmed, but were doing seemingly useless work.

Because of the inefficient bureaucracy, high reporting costs, and inherent weakness of the rule-based system, most countries in Europe adapted the RBA system after 2007. In this system, banks are ultimately responsible for suspicious transactions, and have designed increasingly complex computer systems to determine which transactions are suspicious. These systems are paired with customer due diligence: determining the identity of the beneficial owner of the money being transferred. In other words, according to KPMG, it allows banks to adopt a program that reflects the banks clientele and global position.<sup>114</sup> Thus, banks can tailor their analysis depending on their size and areas of business. A small bank, in theory, should have a different assessment program than a large bank that files hundreds of international transactions a day and conducts business with dozens of overseas banks.

The crux of this system relies on the fact that banks are liable, and can be prosecuted if they fail to report a transaction that is later discovered to be money laundering. The 2005 Directive states that member countries must ensure that “sanctions can be imposed against credit and financial institutions for infringements of the national provisions.”<sup>115</sup> In other words, EU banks must comply with the rules, and the government must ensure not only that the penalties are clear and direct, but also enforced. Thus, the RBA system is dependent on the fact that governments serve as watchdogs for the banking industry.

This then leads to the role that the government plays within the system. Although a switch to a risk-based system shifts more responsibility to banks, the government still has to play an active role. The SARs that a bank files are forwarded on to the respective country’s financial intelligence unit (FIU), who then investigate and determine if this money is linked to crime or terrorism. Ideally this creates a two-way system. Banks act as investigators, supplying information to the FIUs in order to protect their banks and ensure that illicit money does not enter their coffers. In turn, the government ensures banks are fulfilling their role as investigators through periodic inspections. In Spain, for example, inspections

<sup>114</sup> Michael Dawson, “Anti-Money Laundering Enforcement Gets Tougher and Smarter,” *American Banker*, July 26, 2012.

<sup>115</sup> European Parliament, “Directive/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing,” Section 4, Article 39, (2005).

of FIs are done annually, but in other countries, the government regulates through offsite evaluations and less frequent onsite inspections.<sup>116</sup> While the RBA system is an improvement, the government must ensure there is funding for inspections and maintenance of the AML regimes.

While financial institutions are the main organs for the RBA system, there is a growing concern from the EU and the Financial Action Task Force (FATF) regarding non-financial institutions (NFIs). Thus far they are not subject to the same strict regulatory system as FIs. It is undeniable that money launderers are increasingly using NFIs to layer their proceeds and initially deposit their money in banks.<sup>117</sup> NFIs are especially dangerous in that they hide the true identity of the beneficial owner. Real estate and insurance companies are especially vulnerable, yet they lack the regulatory systems necessary to identify and question their customers and investors. If the illegal money is routed through these institutions, placement of capital in a bank is much easier. Most Western European countries only have minimal coverage of NFIs, and the laws regarding regulation are incomplete.<sup>118</sup> Masking the money's origin through NFIs is a major problem that needs more attention from state governments.

### EU Directives and the Banks

Banks have a choice regarding the extent of their AML programs, and it is imperative to remember that, fundamentally, they are businesses. The more questions they ask, the less likely they are to attract customers—especially those who are high profile and wealthy. The invasive background checks of AML programs discourage customers from entering into a business contract, especially when dealing with offshore companies. In fact, the Financial Services Authority report revealed that bank executives actually encourage transactions from offshore companies, even when the ownership of the account is unclear.<sup>119</sup>

<sup>116</sup> "Spain: Basel Core Principles for Effective Banking Supervision," *Country Report 12/142* (International Monetary Fund, June 2012).

<sup>117</sup> "Anti-Money Laundering/Combating the Financing of Terrorism- Topics" (International Monetary Fund, 2000), <http://www.imf.org/external/np/leg/amlcft/eng/aml1.htm>.

<sup>118</sup> "The Application of Directive 2005/60/EC on the Prevention of the use of the Financial System for the Purpose of Money Laundering and Terrorist Financing" (European Commission, 2012).

<sup>119</sup> "A Review of Firms' Implementation of a Risk-Based Approach to Anti-Money

FIs thus face a choice: increase their AML efforts and risk customers taking their business elsewhere, or hope to slip by government regulators. Many are willing to take a chance, and hope that the governments will not notice individual transactions, as long as they are up to date with the laws. Time constraints affect governments, especially in smaller countries. Larger countries have more personnel and sophisticated methods of identifying suspicious transactions, but still transactions go unnoticed. Banks attempt to slip by regulators by inappropriately rating high risk factors as low to avoid due diligence. It thus seems that banks overtly manipulate scoring to make sure that profitable customers are not seen as high-risk.<sup>120</sup> In other words, bank executives and front-line operators will look the other way when it comes to suspicious activity in order to shelter their own interests and avoid alienating customers and discouraging business.

There are two major areas of risk for banks concerning money laundering. The first and most obvious is financial. In the United States in late 2012, banks guilty of money laundering were hit with large fines, including a \$327 million fine for Standard Chartered and around \$1.9 billion for HSBC. While the financial reparations are substantial, for a bank like HSBC, which had a gross profit of \$75.45 billion in 2011,<sup>121</sup> such a sum will not bankrupt them. When assessing financial risk, banks must take into account how much they can potentially make from laundered money, versus how much they might potentially have to pay in reparations. And of course there is always the chance that they will not be caught. The global economic climate will have a major effect on this decision. In times of crisis, for example 2008, criminal money became the most dependable, and sometimes only, source of revenue for banks.<sup>122</sup> Further, other financial matters distracted the governments from counteracting money laundering, thus lowering the risk. Unfortunately, this trend is even more pronounced within smaller, less economically prosperous countries.

The second area of risk for banks is reputational. The extent to which this is applicable can be debated, but basically, banks will be compelled

Laundering (AML)" (Financial Services Authority, 2008), 46.

<sup>120</sup> *Ibid.*, 4.

<sup>121</sup> "HSBC Income Statement," HSBC, accessed December 10, 2012, [http://ycharts.com/financials/HBC/income\\_statement/annual](http://ycharts.com/financials/HBC/income_statement/annual).

<sup>122</sup> Roberto Saviano, "Where the Mob Keeps its Money," *New York Times*, August 25, 2012.

to enforce money laundering because if they are part of a money laundering scheme, they will lose customers who do not want to bank with them. According to Galeotti, this may not be entirely true, since most people are not aware of which banks are laundering money.<sup>123</sup> A further argument against reputational risk returns to the desire for corrupt and secretive banking mentioned before: some high profile customers will want to use a bank that is more likely to keep its customers' transactions secret. This supports the FSA's observation that "senior management [of banks] were willing to take on extremely high risk-risk customers, including where evidence appeared to point towards the customer being engage in financial crime, as long as they judged the immediate reputational risk to be low."<sup>124</sup>

That said, these arguments hold mostly for large banks. Smaller banks are more likely to be compelled to mitigate the risk. On the other hand, the FSA report on British banks revealed that small banks implemented fewer preventative measures, in mostly tick-box regulation, which is not adequate for background checks.<sup>125</sup>

While the banking law of the EU directive is positive, and a step in the right direction, a few major issues must be resolved in the next EU Directive. Most important is the issue of correspondent banking, which continues to be a weakness in the system. Banks in many EU countries are not required to do large amounts of due diligence procedure on transactions that do not warrant suspicion from banks within the EU.<sup>126</sup> According to KPMG, "the majority of European financial institutions do not provide details of originating and beneficiary parties to their correspondent banks [within the EU], preventing the latter from fulfilling their sanction screening obligations."<sup>127</sup> This was originally enacted to save time and money, as it was assumed that EU banks would have adequate safeguards. This law is dependent on regulations by all banks in all countries being equal. As we shall see this is not true. While all EU countries have enacted the laws, the administration of these laws is not uniform. Thus what occurs is that banks trust

<sup>123</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012.

<sup>124</sup> "A Review of Firms' Implementation of a Risk-Based Approach to Anti-Money Laundering (AML)," 33.

<sup>125</sup> *Ibid.*, 40.

<sup>126</sup> European Central Bank, "Opinion of the European Central Bank (COM)(2004) 448 Final," February 4, 2005, accessed December 7, 2012, [http://www.ecb.int/ecb/legal/pdf/c\\_16620130612en00020005.pdf](http://www.ecb.int/ecb/legal/pdf/c_16620130612en00020005.pdf): 2.

<sup>127</sup> "Global Anti-Money Laundering Survey" (KPMG, 2011), 24.

the bank they are receiving money from, and thus layer the money, often unknowingly. This is what we term the *Chain Investigation Effect*. The speed at which wire-transfers of money are being made exacerbates the effect. The risk is too large to allow this correspondent banking system to continue.

As Galeotti has noted, most banks in Western Europe accept laundered money as long as it has been washed in another country.<sup>128</sup> According to the FSA, banks believed that if proceeds of crime were invested in legitimate ventures, the money then became legitimate.<sup>129</sup> Without an effective law that requires banks to do due diligence of other banks within the EU, FIs will continue to layer criminal money, knowingly and unknowingly, making it more difficult to trace at a later stage.

### EU Governments in the 2005 Directive Context

All the governments in the EU have implemented the money laundering investigation laws in accordance with the Directive and the FATF, and banks have for the most part implemented the risk-based system. Ultimately, effectiveness comes down to how well the laws are carried out. Galeotti argues that overall, FIs have not carried out the necessary steps regarding SARs, and the governments have failed to act as proper regulators in order to ensure compliance.

Prevention goes beyond merely enacting laws, and includes the government advocating for increased regulation and accountability. In developing countries, money laundering regulation is a luxury. In these cases, it becomes an issue of priority. Since money laundering's effects are not as easy to detect, many governments in poor countries will opt for a project which directly benefits their people. However, this is not the case in the EU, where infrastructural and financial development is a pre-requisite for membership. Money laundering should be high on the agenda within these countries.

A major problem is that the immediate negative effects of money laundering are not totally obvious, and in some ways the country benefits from it in the short term, as in the 2008 economic crisis, where criminal money supplied banks with much needed capital. It is thus difficult to justify it as a smart business or government move when conceivably many

<sup>128</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012.

<sup>129</sup> "A Review of Firms' Implementation of a Risk-Based Approach to Anti-Money Laundering (AML)."

in society will never feel the negative effects, and in turn banks pay financially for stricter regulation. It is imperative to remember that the long-term effects of money laundering include financial instability for FIs, reliance on unreliable funds, and the rise of a criminal and underground society. All of these are detrimental to the financial and societal health of a nation.

The success of the FATF Recommendations and countering money laundering is not dependent on the laws, but instead on the willpower of the government to actually carry out the laws. FIs and NFIs are getting, in some cases, free passes. The number of prosecutions does not equate with the amount of money laundering that is occurring. While willpower is important, part of this also depends on the FIUs' ability to actually do their job, including addressing funding and staffing issues. However, even the best FIU faces many challenges and hurdles that make it difficult to investigate money laundering.

### The Difficulty of Investigation

Investigations should be divided into two interconnected categories: the ability of individual countries to investigate within their own country, and cooperation with international investigation. Money laundering is a transnational crime, and thus the latter takes on a special significance when evaluating the effectiveness of investigations.

International efforts are based on the joint operations of FIUs, joint investigation teams (JITs), and European arrest warrants (EAW). The success depends on the solid working of these cooperatives, and arguably a control mechanism that makes the whole system less ad hoc. FIUs have already been introduced, but their role within the structure is worth repeating. FIUs form the basis for investigations at the domestic level, using information supplied by the banks through suspicious transaction reports. Each country has its own FIU, which in most, but not all, cases in Europe is under the control of the Central Bank.

The effectiveness of FIUs depends on the country. While most are in line with the FATF recommendations, their weaknesses stem from a variety of issues. A major problem is funding, especially in smaller countries. The lack of funding limits the number of qualified staff since analysts with a higher education are more expensive. However, it is not limited only to small countries; France is also facing problem where "the resources employed to

conduct investigations are not sufficient to cope with the volume of incoming reports."<sup>130</sup> While funding might always be a problem, a minimum standard should be set that ensures that FIUs in the EU are able to do an adequate job. If the country cannot meet this standard, there should be an outlet for funding.

While domestic institutions are important in investigating money laundering, money laundering is a transnational problem, but despite this fact, coordination even within the EU is lacking. JITs and EAWs are key elements within this system, but they are nonetheless limited due to international laws and a lack of total harmonization within the EU. There are two main problems that arise regarding JITs and EAWs: the inability of member states to create similar legal systems that allow for easy investigative assistance, and, in this vein, the lack of a larger EU-wide coordination system.

EAWs have been used within the EU. Indeed, a European Parliament report attests that by 2009 over 1,770 persons had been arrested through EAWs.<sup>131</sup> How many of these arrests were actually tied to money laundering is unknown, but the fact that EAWs are available as a tool is important.

Despite the successes, there are still major roadblocks that impinge on the ability to use EAWs. The same European Parliament report highlights the inconsistency with laws across the EU, which interfere with the efforts and allow for the refusal to provide aid in investigation: "due to the varying national implementation Acts throughout Europe, the grounds for refusal of execution listed in the Framework Decision are often treated differently from one country to the next."<sup>132</sup>

The Nordic countries actually provide an example of where EAWs seem to work well, based on "extradition laws with identical wording."<sup>133</sup> The Nordic Arrest Warrant allows for increased cooperation amongst judicial and investigative bodies, ensuring that there are fewer optional grounds allied with faster processing times and less bureaucracy.

While a European-wide EAW would be difficult to implement, if other EU "regions" can set up similar legal coordination systems,

<sup>130</sup> "Anti-Money Laundering and Combating the Financing of Terrorism: France" (Financial Action Task Force, 2011), 27.

<sup>131</sup> "Implementation of the European Arrest Warrant and Joint Investigation Teams at EU and National Level" (European Parliament, 2009), 3.

<sup>132</sup> *Ibid.*, 20.

<sup>133</sup> *Ibid.*, 22.

these bodies could then work together at a higher EU level. This, however, depends on legal uniformity, which has not yet been achieved.

JITs are another tool for facilitating transnational cooperation, especially amongst EU countries. They have been used for money laundering investigations, and while there have been successes, such as in Bulgaria,<sup>134</sup> the European Parliament reports that they have been used much less than EAWs. There are noticeable problems with JITs, which make them inefficient and seemingly unproductive.

First is the fact that JITs are infrequently used, and, because of this, many law enforcement bodies are reluctant to employ them because of ignorance of the required procedures and administrative steps.<sup>135</sup> Formal cooperation through JITs can be difficult, especially when law enforcement is accustomed to informal coordination channels. These informal channels have been an important part of anti-money laundering efforts, according to *Money Penny*, a Baltic Sea project spearheaded out of Sweden.<sup>136</sup>

This reliance on informal networks makes it difficult to convince law enforcement to use formal, and often time consuming, investigation channels. Part of the difficulty is that JITs are expensive and take time. While work has been done on ameliorating these problems, informal channels are often seen as more effective. Unfortunately, there are also major weaknesses with informal channels: they are only effective when dealing with crimes that involve the countries with which the FIU has a good relationship, and, more importantly, the evidence is not usually permissible in court. Thus they are used as a tool to kick-start investigations, and to procure initial evidence.

A second problem with JITs is that there are questions about admissibility of evidence, and “in trial [it] is governed by the national law of the Member State

<sup>134</sup> Mariana Lilova, “Joint Investigation Teams- Way of Function and Case Studies,” Lecture, May 29, 2012, accessed January 5, 2013, [http://www.rai-see.org/doc/Joint\\_Investigation\\_Teams-way\\_of\\_functioning+case\\_studies-Mariana\\_Lilova-Eurojust-Opatija\\_June\\_2012.pdf](http://www.rai-see.org/doc/Joint_Investigation_Teams-way_of_functioning+case_studies-Mariana_Lilova-Eurojust-Opatija_June_2012.pdf).

<sup>135</sup> “Implementation of the European Arrest Warrant,” 35.

<sup>136</sup> “*Money Penny*” – ISDP launches a new joint project on money laundering with the Swedish National Police,” see website of Institute for Security and Development Policy, accessed January 4, 2013, <http://www.isdp.eu/archive/1-isdp-news/843-money-penny-isdp-launches-a-new-joint-project-on-money-laundering-with-the-swedish-national-police.html>

where the court proceedings take place.”<sup>137</sup> Thus, evidence might not be admissible in a country’s court if that evidence was procured in a different country.

The overall problem with JITs is that issues need to be ironed out; there is, however, great potential. While Europol and Eurojust are involved in the formation of JITs, as the recommendations of the Toulouse Seminar in 2008 states: more effort should be made in coordinating national law enforcement bodies, including providing training on how to set up JITs and use them effectively.<sup>138</sup>

Whereas JITs and EAWs are steps toward enhanced coordination, they are concerned with post-criminal identification. Investigations depend, initially, on well-maintained intelligence. Unfortunately, coordinated intelligence is lacking at the EU level in many respects. Efforts to coordinate intelligence for the most part have been inconsistent. An EU-wide intelligence coordination program suffers from the deep-rooted issue of national sovereignty and distrust.

One example is FIU.NET, which provides a server for intelligence sharing. Data is submitted from each participating country’s records, and, through anonymous data sharing, law enforcement can look for matches in their cases, and in theory track money trails across Europe. However, FIU.NET is voluntary, which leaves gaps in intelligence—for example, the Baltic states are not involved.<sup>139</sup> This is a major drawback, since our evidence shows that these countries are money laundering channels. Thus, the channel is limited, and information is selective and not entirely consistent.

According to the FSA and Galeotti, there needs to be a larger body to harmonize intelligence. However, national sovereignty is a major issue. Countries will not share intelligence if they believe it won’t be used properly in other countries and disseminated under different freedom of information laws. This is both a problem on a computer server and with face-to-face cooperation. Distrust of other countries, especially new members that are viewed as corrupt, propels a system based on suspicion and, at best, informal coordination.

While coordination within the EU is imperative, money laundering investigations are also hampered by the fact that coordination with third party states is often difficult. In practice, the use of bilateral treaties regarding evidence sharing should allow for evidence coordination, though in practice this seems to fail.

<sup>137</sup> “Implementation of the European Arrest Warrant.”

<sup>138</sup> *Ibid.*, 37.

<sup>139</sup> Official website of FIU.NET, accessed December 11, 2012, [www.fiu.net](http://www.fiu.net).

Russia has been especially difficult when it comes to cooperation in investigations. Russian efforts, for the most part, occur when it is politically convenient. Russia bars extradition, which protects Russian nationals from being tried in other countries. In terms of evidence procurement, for AML, “information exchange between Russian authorities combating money laundering and relevant foreign authorities under AML law is possible on the basis of an international treaty upon their request or upon the own initiative of the Russian authorities.”<sup>140</sup> In other words, Russia’s laws allow it to contribute to investigations when it is convenient. Further, their law states that there must be significant evidence in order to begin an investigation. This creates difficulty, since Russia is not contributing the information that it has obtained from its AML initiative, according to Professor William Partlett of Columbia Law School.<sup>141</sup> Russia is a black box for money trails, and if a money laundering investigation leads to Russia, it is very difficult to trace the beneficial owners and thus make a case for a money laundering investigation.

Numerous cases exemplify Russia’s reluctance and difficulty regarding international investigations. In 2006, when Raiffeisen Zentral Bank (RZB) was tied to money laundering in Russia involving the Russian-owned Diskont Bank, the Russian government refused to aid in the Austrian investigation and made no mention of the case in official reports. The Austrian Interior Ministry hit a dead-end, and without the Russian evidence, it was impossible to create a case.<sup>142</sup> In another example, as seen in Operation Avispa in 2005, Russia harbored some of the prime suspects, refusing to extradite Tariel Oniani, a Georgian national seeking refuge in Russia. Even after Oniani’s arrest in 2009 for another crime committed in Russia, the Russian authorities still refused to try him for money laundering or cooperate with authorities in Spain.<sup>143</sup>

Russia’s reluctance to help in investigations remains a major problem. This begs the question, then, of what pressure the EU can really place on Russia. The answer, according to Galeotti, is very little, especially in the

<sup>140</sup> “Russian Country Profile-MLA in Relation to Asset Recovery” (Basel Institute on Governance: International Centre for Asset Recovery), accessed November 29, 2012, <http://www.assetrecovery.org/kc/node/d2d73811-c066-11dd-b3f1-fd61180437d9.html>.

<sup>141</sup> Interview by Alexander Georgieff with William Partlett, December 7, 2012.

<sup>142</sup> Natalia Morar, “Officials are Taking Money Away to the West,” *The New Times*, May 21, 2007.

<sup>143</sup> “Tariel Oniani’s case has united Moscow and Tbilisi,” *Georgia Times*, June 16, 2009, accessed December 13, 2012, <http://www.georgiatimes.info/en/interview/14684.html>.

short term.<sup>144</sup> Notwithstanding, he does argue that there has been a slow improvement of the situation. In fact, a major development is that shell banks are being squeezed out of Russia, and as a result, money is being laundered through legitimate banks. In a roundabout way, this actually helps with investigations, since international banks have an increasingly larger presence within Russia. If money is laundered through a foreign bank in Russia, the country that owns the bank in question has the ability to request information from that bank. As banking becomes more international within Russia, there exists the hope that this will discourage Russia from withholding evidence and harboring criminals.

### All is Not Lost

While the review of investigations and EU efforts to stop money laundering has been pessimistic, it would be inaccurate to believe that all European countries are failing to implement and create change and that there have been no positive results. It must be remembered that money laundering is an extremely difficult crime to investigate. As money laundering and its perpetrators become more advanced, more time must be spent on each link in the money trail. That is why it is important to stop money laundering at an early stage, and at the financial gates of the EU.

The efforts of countries in Western Europe have improved. In the mid-2000s, Spain began a crackdown on those Russian criminal enclaves within the country with major ties to money laundering. The money that had been used to buy villas in Malaga had been laundered across Europe. In Operation Troika in June 2008, Spanish authorities arrested the kingpin of the criminal network, Russian national Gennadios Petrov, in addition to twenty other men on suspicion of criminal and money laundering activity. Following the arrests, media sources began to receive intercepts that revealed Petrov’s connections within the Russian government, and warned of unintended consequences of the arrests.<sup>145</sup> While no specific criminal connections have been made to Putin, it undeniable that Petrov was well connected within Russia, including with Igor Sechin, a member of the Siloviki and ally of Putin.<sup>146</sup>

<sup>144</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012.

<sup>145</sup> “Grand Operation,” *Novaya Gazeta*, June 25, 2006, accessed September 18, 2012, <http://en.novayagazeta.ru/politics/8265.html>.

<sup>146</sup> “Grand Operation.”

In Germany, there have been efforts targeted against banks involved in money laundering out of Russia. While not tied directly to ROC, the prosecution of Commerzbank in 2008 reflects Germany's campaign against Russian money laundering. From 1999 to 2008, Leonid Reiman, owner of a large part of Russia's telecom industry, used offshore companies to launder \$150 million through Danish lawyer Jeffrey Galmond.<sup>147</sup> Those offshore companies, controlled by Galmond, were used to launder the money into Commerzbank AG. Commerzbank was charged with failure to accurately disclose its assets, but the case ended in a settlement, with four representatives of Commerzbank and Galmond paying 5,000–40,000 euros each.<sup>148</sup> Reiman himself, however, was not involved in the settlement, and the Russian government told the German authorities that they had found no evidence that he was involved in money laundering out of Russia.

These two cases show that efforts are being made, and that the mechanisms of investigation and prosecution do work in the EU. However, these cases also demonstrate that a lack of Russian cooperation can result in a failure to bring the major culprits to stand trial.

### Where are the Weak Links?

With this inconsistency across the EU, Europe is faced with a major problem: weak link nations that allow for money to enter the EU, seemingly unchecked. As was discussed earlier, the EU banking world functions in a way that once money has entered the EU financial system, due diligence regarding inter-union bank transfers dissolves. This is based on the fact that EU banks believe that other EU banks have done their job, and that the governments have ensured that banks are consistent. This ideal has not been realized, and the weak link countries along the eastern border of the EU provide a channel for illicit money.

While the examples are numerous, the VEF Bank scandal in Latvia of 2005 exemplifies the problem. This bank was found guilty of laundering

millions of criminal dollars to Western banks. As a result, the U.S. imposed sanctions on the bank, prohibiting the FI from doing business with U.S. customers. This resulted in the bank liquidating millions of criminal dollars.<sup>149</sup> In another example involving Latvia, in 2008 an offshore company named Tormex laundered millions of dollars from Russia through Baltic International Bank for a period of 12 months before the authorities even took notice.<sup>150</sup> What is troubling is both the bank's non-compliance, but also that government regulation of this particular bank was so lax.

Who is responsible for this problem is not entirely clear, but in a system based on accountability, we should be able to pinpoint responsibility. Is it the banks, the state governments who regulate the banks, or even the EU itself? Each of these groups will be explored throughout the rest of this chapter, and will cumulate in policy recommendations in Chapter 5.

### Banks will be Banks

"Banks will be Banks" — this phrase is apt when describing banks throughout the world. Banks are, at heart, businesses — businesses that resist regulation and prioritize risk to maximize their profit. It is this fact which makes regulation difficult, and, at times, inconsistent. There is a constant struggle for banks to show the government that they are regulating, but, in accordance with their own business interests, that they are not regulating too much. This inconsistency, which occurs throughout the EU financial world, fuels a system that ultimately allows for money laundering to persist.

In 2011, KPMG released a comprehensive macro review of banks worldwide, concentrating specifically on bank management and efforts to target money laundering. Their results reveal some disturbing trends amongst FIs, especially regarding the overall concern bank managements' attribute to money laundering. Since 2007, the percentage of senior management rating money laundering as a crucial issue has declined from 71 to 62 percent.<sup>151</sup> However, KPMG's outlook for Eastern and Central Europe as well as Russia is optimistic, praising them for increased scrutiny of money laundering and

<sup>147</sup> "Leonid Reiman and Jeffrey Galmond/IPOC Case" (Stolen Asset Recovery Initiative: World Bank- UNODC), accessed October 23, 2012, <http://star.worldbank.org/corruption-cases/node/18669>.

<sup>148</sup> David Crawford, "Germany Steps Up Russian Money Launder Probe," *Wall Street Journal*, December 14, 2012; Samuel Rubenfield, "Germany Ends Probe Implicating Russian Corruption," *Wall Street Journal*, April 14, 2012.

<sup>149</sup> Financial Crimes Enforcement Network, "Amendment to the Bank Secrecy Act Regulations — Imposition of Special Measure Against VEF Banka," *Federal Register* 70 (2005).

<sup>150</sup> "The Phantom Account," *The Proxy Platform*, November 20, 2011, accessed October 3, 2012, <http://www.reportingproject.net/proxy/en/the-phantom-accounts>.

<sup>151</sup> "Global Anti-Money Laundering Survey" (KPMG, 2011).

attention from their senior management.<sup>152</sup> They also argue that “there are clear and significant legal and reputational risks for those financial institutions that do not focus sufficiently on developing, implementing and monitoring a robust AML strategy.”<sup>153</sup> While the framework may be developed by banks, the actual carrying out of regulation is at times dubious. While opinions from bank representatives surveyed in the region point toward compliance, evidence from the region seems to suggest otherwise. Of course, these issues vary from bank to bank, and state to state. There are banks, especially those that are smaller, that will not risk being caught. But there are other banks that will choose to take greater risks, and of course cover their tracks.

One of the major areas in combating money laundering is identifying politically exposed persons (PEPs). These include politicians, their families, and others who have access to state funds. Banks find information about these persons through lists that they purchase or create on their own.<sup>154</sup> While the trend in Central and Eastern Europe is to use a combination of both purchased and created lists, 10 percent of banks did not know or refused to answer what lists they use—which is by far the highest rate of any region surveyed.<sup>155</sup> The lack of adequate risk assessments is also a problem in the other parts of Europe. In a recent study of British banks, it was found that more than one-third of banks surveyed did not have adequate anti-PEP risk analysis programs.<sup>156</sup>

Overall, KPMG’s report points toward the need for senior management to take a greater interest in money laundering, and, according to KPMG, “as long as KYC is treated as a compliance issue, as opposed to a business issue, it is unlikely that institution will deliver robust and sustainable controls for maintaining quality and consistent data.”<sup>157</sup> This returns to the issue that businesses see regulation as a burden, and thus will be reluctant to contribute. They frequently do not see the short-term benefit of regulation, and actually see non-compliance as potentially profitable.

## Government Weakness

While not all EU governments have failed in their AML campaigns, there are major inherent weaknesses within the FIU system that explain why money laundering continues to go unchecked. Government FIUs must be well-staffed and extremely dynamic bodies that are willing to adapt to changes. Latvia’s investigation response in the Russian Tax Fraud case of 2007 was delayed by four years despite evidence issued by Hermitage lawyers. Quick government reaction time is imperative. A delay of four years, as in this case, makes it even more difficult to locate capital, and bring a case against guilty banks.

Money laundering must be seen as a high-risk venture for FIs. The government must make sure that the incentives are there for banks to comply, and not take the risk of laundering money. According to Galeotti this can be done in multiple ways: constant fear of being caught, but with smaller fines, or a large fine for a select few culprits.<sup>158</sup>

Punishing banks for a lack of regulation is usually manifested in fines. Banks that fail to implement effective AML systems, which the regulators identify in their inspections, are subject to fines outlined within their individual country’s AML laws. Failure to report suspicious activity is also met with a discretionary fine. However, these fines are dependent on a well working regulation machine, one that not only uniformly investigates banks, but also has the power to ensure that banks have an interest in continued compliance.

The question is thus: why are governments not doing enough, and wherein lies the weakness? Is it because of corruption, ineffectiveness, or a lack of resources? The answer to this is not totally clear, and is most likely a combination of all three, depending on the country. Indeed, the extent of the presence of corruption is a complicated issue, and is very difficult to pinpoint. However, a few factors highlight the possible infiltration of corruption at the government levels.

Before looking into this issue, it is important to mention Gnutzmann, McCarthy, and Unger’s theory of small states.<sup>159</sup> In essence, because small states do not think they will feel the adverse effects of money laundering, they allow for it to continue. Thus, they allow their banks to act as transit channels.

<sup>152</sup> Sixty percent of senior management in Eastern and Central Europe as well as Russia see money laundering as a major issue of which they regularly take note.

<sup>153</sup> “Global Anti-Money Laundering Survey,” 65.

<sup>154</sup> *Ibid.*, 20.

<sup>155</sup> *Ibid.*

<sup>156</sup> “A Review of Firms’ Implementation of a Risk-Based Approach to Anti-Money Laundering (AML).”

<sup>157</sup> “Global Anti-Money Laundering Survey,” 4.

<sup>158</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012.

<sup>159</sup> Hinnerk Gnutzmann, Killian J. McCarthy, and Brigitte Unger, “Dancing with the Devil: Country Size and the Incentive to Tolerate Money Laundering,” *International Review of Law and Economics* 30 (2010).

While it can be argued whether eastern border-states of the EU actively support money laundering, it is clear that their banks do act as transit zones, as multiple cases have shown, including the 2007 Russian Tax Fraud Scheme.

If we believe this theory to be true, is there evidence that points toward government involvement? One of the more concerning trends regarding the eastern EU states, including Romania and Bulgaria, is the fact that there are many alleged connections with politicians in regard to money laundering. In Romania, for example, MP Mihael Boldea was accused in 2012 of setting up an organized crime and fraud ring and laundering money out of Romania.<sup>160</sup> In Latvia, the oligarchs that remained in power from the 1990s, including most notably Transport Minister Ainars Slesers, former Prime Minister Andris Skele, and former mayor of Ventspils Aivars Lembergs, have all been implicated on fraud and money laundering charges.<sup>161</sup>

The connection between politicians with organized crime and money laundering is concerning. While it may be a legacy of the 1990s and communist rule, the persistence of fraud in the public sector should raise red flags regarding regulation. If governments are allowing money laundering to continue either for their own profit or because they are directly involved, the EU should be concerned.

While corruption can be a major reason for the weakness of regulation, the less cynical viewpoint is that these governments are ill-funded and understaffed, making them inefficient and unable to do their job. While the KPMG report has noted that analysts in FIs are of a high caliber amongst Eastern and Central European countries, a lack of resources in the government fails to attract the needed expertise. According to the International Monetary Fund, “to be able to achieve its objectives, an FIU needs resources commensurate with its size and the amount of data it is expected to receive, process, and disseminate.”<sup>162</sup> The size of the FIU should not just be directly proportional to the size of the financial sector, but also to amount of risk. For example, the gatekeepers of the EU<sup>163</sup> should have increased FIU staff-

ing and funding for their banks, which have been pegged as traditional channels of laundering. If these channels are not properly protected, due to the current state of correspondent banking law, the whole union is at risk.

A comparison of the number of employees in the FIUs reveals concerns regarding understaffing: Latvia hires 19 employees; Estonia has 17 employees but only six employees in the analysis division.<sup>164</sup> France’s FIU, Tracfin, has 67 employees, of which 46 are in investigative positions.<sup>165</sup> A look at the comparison between the number of suspicious transaction reports (STRs) gives a good overview of the amount of work each FIU faces. France, a major financial center, received 20,252 STRs in 2010.<sup>167</sup> Latvia received 15,467 from January through October 2011. Estonia, on the other hand, only received 4,317 in the same time period. Latvia is notable for two reasons: one, it receives a strikingly similar amount of STRs to France, yet has a third of the number of employees of Tracfin. Two, Latvia has virtually the same number of employees as Estonia in its FIU, but Estonia receives a third of the STRs that Latvia receives. From this, it is evident that Latvia’s FIU is understaffed, especially when considering that media has touted the country as the “Switzerland of Eastern Europe.”<sup>168</sup>

One of the dangers with an understaffed FIU is the reliance on banks themselves to do their job. The number of STRs that Latvia’s FIU can process is limited, and the chances of overflowing the system are very high. This could occur if banks decide to over-report in order to avoid liability, which is also known as “crying-wolf.”<sup>169</sup> While the crying-wolf problem has been a major problem within the U.S., where fines are much higher for false positives, it is also a potential problem for smaller countries. Thus, if these

<sup>164</sup> “Latvia,” Know Your Country, accessed October 30, 2012, <http://www.knowyourcountry.com/latvia1111.html>.

<sup>165</sup> “Estonia,” Know Your Country, accessed October 30, 2012 <http://www.knowyourcountry.com/estonia1111.html>.

<sup>166</sup> “2008 Annual Report,” Tracfin (2008), accessed December 12, 2012 [http://www.economie.gouv.fr/files/files/directions\\_services/tracfin/pdf/rap2008\\_ang.pdf](http://www.economie.gouv.fr/files/files/directions_services/tracfin/pdf/rap2008_ang.pdf).

<sup>167</sup> “France,” Know Your Country, accessed November 5, 2012, <http://www.knowyourcountry.com/france1111.html>.

<sup>168</sup> Aaron Eglitis, “Swiss-Style Latvian Banking Hub Thrives on Ex-Soviet Cash,” *Bloomberg News*, August 20, 2012, accessed October 16, 2012, <http://bloomberg.com/new/2012-08-29/swiss-style-latvian-banking-hub-thrives-on-ex-soviet-cash-flood.html>.

<sup>169</sup> Brigitte Unger and Frans Van Waarden, “How to Dodge Drowning in Data? Rule- and Risk-Based Anti money Laundering Policies Compared” (2009), accessed November 2, 2012, [http://igitur-archive.library.uu.nl/fss/2013-0501-200819/09-19\\_2.pdf](http://igitur-archive.library.uu.nl/fss/2013-0501-200819/09-19_2.pdf): 6.

<sup>160</sup> Freedom, Legality, and Rights in Europe, “Romania: MP Mihail Boldea Laundered Money for Human Traffickers,” March 28, 2012, accessed December 13, 2012, [http://www.flarenetwork.org/learn/europe/article/romania\\_mp\\_mihail\\_boldea\\_laundered\\_money\\_for\\_human\\_traffickers.html](http://www.flarenetwork.org/learn/europe/article/romania_mp_mihail_boldea_laundered_money_for_human_traffickers.html).

<sup>161</sup> “Latvia,” *Freedom House* (2012), accessed December 12, 2012, <http://www.freedomhouse.org/report/freedom-world/2012/latvia>.

<sup>162</sup> “Financial Intelligence Units: An Overview” (International Monetary Fund, 2004), 7.

<sup>163</sup> This includes: Bulgaria, Estonia, Greece, Latvia, Lithuania, Poland, and Romania.

countries begin raising fines for non-compliance, an increase of STRs could drown the already fragile system. Banks involved in money laundering could also send large amounts of STRs in order to evidence their regulation. In other words, the fines would do more harm than good, increasing the likelihood that money launderers would slip through the regulatory offices.

The inability for FIUs to monitor, whether this is from corruption or lack of funding, allows illicit money to continue to be laundered. Even if fines are imposed, the ability of the FIU to instate these fines is limited by its own capacity. Arguably, banks make note of the ability of the government to effectively regulate their efforts. In other words, the banks are willing to call the government's bluff on this issue, allowing for money to continue passing through their coffers, not fearing reparations.

## **Conclusion**

Whether we believe the eastern EU border-states are part of the small economic state theory or not, the failure to stop money laundering has drastic effects on the EU. Because of the weak channels that exist, it is easy to get money into the EU. The border-states, while economically small, must remember they are part of a larger economic union. The influx of crime and instability that money laundering brings deteriorates the whole union's economic health, especially at a time of weak economic stability. Thus if the larger economic union suffers in the long term due to money laundering, these small states will suffer as well.

It must not be forgotten that the failure to stem money laundering does not come from one source. We cannot solely blame the banks or the government. Both governments and banks are part of the mechanism, and both are dependent on the other to ensure the tracking of money laundering. Thus the two traditional adversaries must work together. This requires that we look at the system as a whole. Banks will continue to resist regulation until they find that it is worthwhile. It is the role of the government to ensure that banks understand why it is in their best interest to comply, be that through fines or through cooperation. Unfortunately, governments cannot track money laundering without banks. However, the more disturbing question is, what if the governments do not take the necessary steps? This is a realistic scenario that requires a higher body of accountability.

The final chapter will look into policy suggestions for governments to ensure bank compliance, but also ask the question if there is an institution higher than state governments that can ensure accountability. A more federal system in the EU might be necessary, notwithstanding issues of national sovereignty.

## The Future: Policy Recommendations to Counter Money Laundering in the EU

The continuation of money laundering in the EU facilitates the international spread of Russian organized crime (ROC). While the EU Directive of 2005 does place increased emphasis on bank involvement in the fight against organized crime, the problem is what to do when banks fail to regulate, or they themselves are involved? As detailed in previous chapters, enough banks are involved in money laundering to cause alarm and necessitate a thorough questioning of current policies in the EU.

This chapter will assess and recommend changes to all levels of the structure: the banks, the national governments, the EU, and the Financial Action Task Force (FATF). As former agent for the IRS, Robert Mazur notes: “there needs to be an initiative of law enforcement to address the internal threat within financial institutions.”<sup>170</sup> Adequate law enforcement relies on all levels, and these recommendations are based upon the need for more accountability within the whole system. Accountability is lacking due to inconsistent regulation and a lack of funding that hinders the ability of law enforcement and governments to effectively investigate and monitor financial institutions. This is arguably even more of a problem in smaller EU states, which often lack adequate resources. Thus, this issue requires a reassessment of funding sources to ensure that these FIUs have the ability to carry out their duties.

The levels outlined above rely on information exchanges that require cohesive reform that facilitates streamlined cooperation. Thus, the policy changes that we recommend must be considered as a whole, not as singular recommendations. Galeotti outlines two main suggestions that are necessary in the fight against money laundering. The first is to increase deterrence for FIs, providing them with a good reason not to launder illicit money. This includes punishing the banks, including their CEOs and board members. Second is that the FIUs must institute intelligence-

led policing that takes advantage of reliable cross-border intelligence.<sup>171</sup> These two areas will form the basis of our policy recommendations.

### What will Happen if Nothing is Done?

Before outlining the policy suggestions, it is important to briefly touch on what will happen if nothing is done. Based on the current policies in the EU, there are two main categories of ramifications that can potentially occur if change is not implemented.

First, there will be a growing infiltration of crime in the EU. Criminals generally follow their money, and as has been seen in the south of France and Spain, they create mafia colonies that integrate into society. While the money is invested in the economy of the country through property and real estate, there are costs, most importantly crime. Criminals increase the potential for violence in the community, as well as bring drugs and smuggled weapons.

A major question is how these criminals are able to follow their money, especially since they are often Russian, rather than EU nationals. An answer to this is that many of them obtain EU residence permits through countries such as Estonia.<sup>172</sup> Russians take advantage of their connections in EU governments, and with enough money, they buy their way into the EU.

The potential for increased violence requires improved and expensive monitoring of mafia colonies. Most countries understand the risk of allowing Russians in, and that policing costs are a burden on society. However, legitimate businesses involved with mafia colonies might not always feel this cost, resist government action, and fail to regulate. This should be major consideration for governments in the cost-benefit analysis regarding the allowance of money laundering. The government must work with the private sector to recognize these risks, and work together to prevent the infiltration of organized crime.

Second, money launderers pose a long-term financial risk to financial institutions. While in the short term banks make a profit and benefit

<sup>171</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012.

<sup>172</sup> Euan Grant, “The Russian Mafia and Organised Crime: How Can this Global Force be Tamed?” *Open Democracy*, October 12, 2012, accessed January 4, 2013, <http://www.opendemocracy.net/od-russia/euan-grant/russian-mafia-and-organised-crime-how-can-this-global-force-be-tamed>.

<sup>170</sup> “An Interview with Robert Mazur,” KYC360, <https://www.kyc360.com/hot-topics/An-Interview-with-Robert-Mazur/>

in times of crisis, illicit capital is harmful in the long run. Transnational crime distorts market mechanisms according to an analyst at the Canadian Security Intelligence Service.<sup>173</sup> By infiltrating the legitimate economy with illicit capital, criminals are “depriving consumers and producers of the benefits of fair, free, safe and secure economic and commercial systems.”<sup>174</sup>

Russian criminals often follow their money to their destination, and in addition to increased violence and smuggling, the long-term economic harm to countries is evident. However, small economic countries that merely act as transit zones, such as the eastern border-states, will not feel either of these effects as much as countries like Spain or France. Thus, the eastern border-states may be more likely to allow the money to pass through. If they are not compelled to stop money laundering, they will continue to fuel the system.

### Policy Recommendations Regarding FIs

A major problem with the enforcement of money laundering is that banks themselves are reluctant to regulate. This weakens the potential for using the banks as tools to apprehend money launderers. Banks want only to carry out the bare minimum of regulation. As noted in Chapter 4, this is not only to save costs for themselves, but also to attract customers who prefer less invasive background checks and monitoring.

While many FIs, especially international banks, will forward information on some suspicious transactions, a look at the money laundering charges of banks in 2012 reveals that not all suspicious transactions are being reported. For example, in the case of HSBC and Mexican drug cartels, huge transactions were being carried out, day after day, and the bank did not report them.<sup>175</sup> The 2011 FSA report further supports this conclusion, noting the banks’ senior management’s reluctance to report in the EU.<sup>176</sup>

The governments’ goal is to increase the number of quality STRs from banks. There are two directions in terms of policy in order to

<sup>173</sup> Samuel D. Porteous, “The Threat of Transnational Crime: An Intelligence Perspective” (1996): 3.

<sup>174</sup> Ibid.

<sup>175</sup> Carrick Mollenkamp, “HSBC Became bank to Drug Cartels, Pays Big for Lapses,” *Reuters*, December 12, 2012, accessed January 2, 2013, <http://uk.reuters.com/article/2012/12/12/uk-hsbc-probe-idUKBRE8BA05K20121212>.

<sup>176</sup> “A Review of Firms’ Implementation of a Risk-Based Approach to Anti-Money Laundering (AML),” 33.

achieve this goal: either allow the FIs to continue to monitor, but create larger incentives to regulate, or give the government more of a role.

### The Need for Fines

Do fines work? Success depends on the type. One option is to have more widely implemented fines, but with less punitive costs. The benefits of this type are that banks will feel a constant pressure to monitor and encourage continual surveillance. Further, the fines would not be crippling, especially for smaller banks, and allow them to remain buoyant and work toward improving their regulatory structure. However, this strategy requires frequent inspections, both on and off site, which are costly for governments. The government would have more of a role in monitoring banks directly. Nonetheless, it would be dangerous to implement “budget” government strategies. Thus, governments must have the capabilities to carry out this regulation. Money obtained from fines, however, should compensate for the higher costs.

This strategy advocates for more government regulation, even for banks that are regulating at an adequate level. This can ultimately be counterproductive for the government. One suggestion is to allow banks with good regulatory track records less government surveillance, but higher fines if they are caught. This would be determined by government-wide inspections of FIs. Those FIs that either have a history of money laundering or have failed an FIU investigation will come under surveillance for a trial period. During this time, employees would be provided with enhanced training, and suspicious activity reporting would be monitored. If regulation improves, the surveillance will be lifted, but the FI will still be pegged for government attention.

The second option is to impose large fines on a few banks. In other words, make an example to compel other FIs to comply with the laws. The ultimate goal of this strategy is that the large fines would be so crippling to FIs that most would fall in line in order to avoid the risk of bankrupting or debilitating their bank. This strategy requires fewer resources from the government by scrutinizing fewer banks. However, financial institutions must feel like that they are being monitored in order for this strategy to be successful. Thus, the government must have a regulatory presence.

From our experience, the first strategy would be the most effective in actually compelling banks to monitor and submit quality STRs. The reason

for this is the concept of balancing business risk. Banks traditionally will take large risks concerning fines when the latter are unlikely to be imposed. This is especially true with large, international banks. Many agree that major international banks are most prone to money laundering, due to their size and international reach. Thus a constant risk of being caught could compel banks to implement effective monitoring systems. Indeed, such an incessant risk of fines could, in many regards, have a greater effect than infrequent larger fines.

In addition, this bank strategy must include liability for CEOs and board members, who must face criminal charges if their banks are implicated in money laundering. According to Mazur, “until the sounds of clicking of handcuffs becomes common in the board rooms of the banks that do this, then [money laundering] will continue.”<sup>177</sup> Bank personnel, especially those in decision-making positions, must have an interest in maintaining adequate regulation. Legal liability and fines would hopefully deter those bank officials who seem lenient with wealthy customers from ignoring know-your-customer protocol and correspondent banking.<sup>178</sup>

What is particularly contentious for FIs is the increased government presence in everyday regulation. However, FIs have regularly broken laws, and thus the government must take a more active role to ensure regulation. Nonetheless, the government cannot afford to isolate FIs either. In reality, they are the eyes and ears for the government. FIs are in such a position that it is advantageous to use them as a tool for regulation. One option, according to Galeotti, is that governments could monitor predominantly in high-risk areas. If a financial institution wants to do business with an offshore company in a certain jurisdiction, such as the Cayman Islands, they must pay an administrative fee to the government, which the government would use to carry out extra due-diligence.<sup>179</sup> If the government identified money laundering, the government could confiscate the proceeds and go after the criminal. It would give the government a hand in the financial system, but predominantly in high-risk areas. Hence, smaller banks, which do not deal with offshore companies and networks, would suffer from less government involvement.

For this plan to be achieved, the government would have to implement this policy industry wide, and codify it in law. If a major bank did

not implement this strategy, the money launderers could just take advantage of the weakest route. Further, bank secrecy laws might have to be modified in certain countries, allowing the government access to financial information. What this would ultimately do is limit the use of offshore companies. Money launderers would be forced to go through other networks, such as legitimate businesses, which in turn should be regulated.

### Accountability of the Government

Within these policy recommendations is the assumption that governments provide adequate accountability to financial institutions. This is not always true. In the current system, the AML policy is only as good as the government that is regulating FIs. If a governments' anti-money laundering program is ineffective, corrupt, or lacking in resources, banks themselves will not have the incentive to monitor, and will determine the risk as low.

To explain why this occurs we can return to the small-state theory: smaller states will have less incentive to monitor because they are less likely to feel the negative effects of money laundering.<sup>180</sup> We can also choose to believe that economically small states just do not have the capacity to regulate and prevent money laundering. In either scenario, once the illicit money enters the EU it is easily disseminated due to lax inter-Union correspondent banking.

Because EU states are members of a larger economic union, the EU must require a governing body that ensures that all member states have not only implemented the appropriate laws in compliance with the EU Directive, but are also enforcing it to an adequate level.

There exist institutions that have the potential to fulfill this role, including the European Banking Agency (EBA), which is part of the European Supervisory Authorities (ESAs). The goal of this Agency is that “in a crisis, the ESAs will provide EU-wide coordination [and] the ESA may make decisions that are binding on national supervisors.”<sup>181</sup> However, legally, the EBA lacks the authority to do much beyond developing regulatory standards for member states, which the Fourth EU Money

<sup>180</sup> Gnutzmann et al., “Dancing with the Devil: Country Size and the Incentive to Tolerate Money Laundering.”

<sup>181</sup> “European Supervisory Authorities” (Financial Services Authority), accessed January 5, 2013, <http://www.fsa.gov.uk/about/what/international/european/esas>.

<sup>177</sup> “An Interview with Robert Mazur.”

<sup>178</sup> As noted in the FSA 2011 Report.

<sup>179</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012.

Laundering proposes to improve.<sup>182</sup> According to Dr. Elaine Fahey, “the EBA does not appear to establish anything close to a supranational regulator at the EU level.”<sup>183</sup> Fahey is quite pessimistic of the EBA, stating that it even lacks the ability to implement general regulatory measures.

One of the major problems with the EBA is that it is too broad. The agency was set up to monitor banks generally; rather, a *specific* AML regulation unit, similar to a federal FIU, should be created. The European Anti-Fraud Office (OLAF) seems the likely candidate, but the institution must be given direct supervisory and regulatory authority of national FIUs. Periodic inspections should be undertaken to determine the weaknesses within the system. Thus the institution would act as an advisory board as well as a regulator. They must have the power to reprimand governments who fail to carry out periodic investigations of their own banks.

However, if the failure of national FIUs is an issue of funding, and small states lack the proper resources, the EU agency must be willing to provide adequate funds and training. The role of the agency should be to identify these weaknesses through bi-annual FIU inspections.

While the EU should supply the needed resources, the member state must ensure that the resources are going toward the improvement of regulation. Like at the national level, the EU agency inspections would provide the intelligence on whether FIUs are adequately fulfilling their roles and securing the EU borders. This would also involve the training of FIU personnel, and providing the expertise in order to ensure speedy training and implementation of laws. The combination of increased FIU regulation and more training will ensure that FIUs in small countries will be at the same standard as FIUs in larger countries. In other words, training and coordination will not be to facilitate the light bulb effect, but guarantee that FIUs can work together.

In terms of intelligence sharing, the EU agency should move toward becoming a central standardizer of intelligence. While this will be a challenging step, a formal intelligence-sharing forum, that includes all EU countries, must be created. As Galeotti argues, money laundering can only be counteracted through intelligence-led policing, relying on up to date, transnational

<sup>182</sup> “The EU 4<sup>th</sup> Money Laundering Directive: The New Framework Emerges” (Clifford Chance, 2012).

<sup>183</sup> Elaine Fahey, “Does the Emperor Have Financial Crisis Clothes? Reflection on the Legal Basis of the European Banking Authority,” *Modern Law Review* (2011): 12

information.<sup>184</sup> All countries must be involved in order to minimize weak channels. Allowing countries to not participate creates intelligence black boxes within the Union, adding to the difficulty of tracking money trails.

Regional cooperation could be an avenue to effect change. FIUs and government intelligence groups within a region often work well together, where similar laws and values help to facilitate trust. These relationships should be increasingly formalized. In addition, the regional authorities should be accountable to the EU agency, meeting regularly in order to facilitate information and intelligence sharing. One of the major hindrances to cooperation has been distrust between countries, but by beginning to bridge this hindrance through regional agencies, these agencies might be better vehicles for aiding cooperation at the EU level.

In all of this, it cannot be stressed enough that money laundering from Russia is a EU-wide problem. If the EU banking sector continues to allow for lax correspondent banking within the Union, it must ensure that all banks are able to comply with the EU directive. While national sovereignty is a major issue, in terms of national and financial security for the EU, there must be accountability that ensures that member states are maintaining a standard necessary for protecting the Union.

The need for enhanced power of OLAF, for example, is not to make OLAF a regulator (like the United States’ FIU: FinCEN), but instead ensures that FIUs are doing their job. OLAF would not be in charge of regulating transnational transactions, but instead monitoring whether the laws and policies have been adopted and are being implemented lower down.

### **The Role of the FATF: The Need for International Accountability**

While the EU should step-up their accountability, the FATF should be playing a greater role in ensuring that laws are actually being carried out, not just in the EU, but amongst all its members. Money laundering is a transnational issue, and the more that countries do not comply with money laundering laws, the more expensive it is for other countries in terms of due diligence and identifying suspicious transactions. The FATF has been a guiding institution, outlining 49 recommendations, which provide the blueprints for countries regarding the set-up of FIUs and the

<sup>184</sup> Interview by Alexander Georgieff with Mark Galeotti, December 6, 2012

RBA system.<sup>185</sup> The organization is made up of 36 members, including all major economies. Their periodic evaluations have supplied needed policy advice and recommendations necessary for ensuring adequate laws.

However, what exactly is the use of the FATF in 2013? The FATF could be a leader in ensuring enforcement, but lacks any real ability for this to occur.<sup>186</sup> While their blacklists inform the international financial community which countries are not up to date with money laundering protocol, there is no real deterrence from conducting business with these countries. One of the major problems is that the evaluations focus predominantly on whether laws have been adopted. While important, this distracts from the most pressing issue of whether countries actually are enforcing their laws. Thus, the results of the evaluations are merely confirmation that laws are in place.

It is accepted that most countries will adopt AML laws recommended by the FATF. The heart of the problem, which we have seen manifested in the EU throughout this report, is that states will feel customer exclusion if they enforce these laws. Especially in smaller countries, clients will not use certain FIs with stricter background checks. Thus, countries have a short-term interest not to enforce the laws. In order to counter this, the FATF must push for financial exclusion for countries that fail to enforce laws or punish non-compliant FIs.

What the FATF needs is economic clout. Without clout, the FATF's role is limited to recommendations and evaluations, but will not ensure adequate change among its member countries. If FATF is to be an advisory group, then leave it that way, but internationally there must be a group that places pressure on governments to implement their recommendations. The UN itself could take on this role, but thus far it has not used economic power to enforce change regarding money laundering. Currently the FATF recommendations are tied to USAID and other relief organizations.<sup>187</sup> However, most member countries are not part of the developing world, and thus are not dependent on USAID or UNDP. The FATF "suggestions" must be backed up by economic action from the G8 itself, who must press for increased diligence with the countries they do work with.

<sup>185</sup> "Financial Action Task Force Mandate (2012-2020)" (Financial Action Task Force, 2012).

<sup>186</sup> James Thujo Gathii, "The Financial Action Task Force and Global Administrative Law," *Journal of the Professional Lawyer* (2009): 200.

<sup>187</sup> *Ibid.*, 208.

The G8 must become the leading power within the FATF, instituting their economic clout through the organization. Originally, the FATF was designed as a tool for the G7, protecting the financial interests of the leading economies.<sup>188</sup> According to Professor William Partlett, one option would be to return to the G8 model.<sup>189</sup> The FATF cannot institute sanctions and effective blacklisting against non-complying countries when 36 member countries are involved. The group is too large and there are too many conflicting interests to implement economic pressure.

The G8 has a vested interest in money laundering regulation, since these countries are the ultimate destination of most of the criminal money. The FATF would still suggest blueprint recommendations internationally, but these would be enforceable by G8 muscle power. This is dependent on the countries coming together to decide where to put pressure. The mutual evaluations and blacklists would play a crucial role in this. Thus, the evaluations must be increasingly focused on implementation of laws. With this information, the FATF could begin placing economic pressure on blacklisted countries. If the FATF decided that a country was not implementing adequate measures to prevent money laundering, it could institute sanctions. Thus, the FATF would gain power as a direct tool of the largest economies, who are the ones that suffer most from money laundering.

These recommendations are dependent on reassessing the FATF. At the moment its powers are limited, and if that is what UN believes its role should be, they must find other ways of pairing with the FATF an organization to place economic pressure on governments. Merely stating expectations does little to make any changes, and is a waste of money and effort. Their focus on laws, and not on enforcement, provides an unrealistic portrait of the country's AML efforts.

## Conclusion

The policy recommendations above are preliminary suggestions based on a study of the current weakness of the system. While the EU does not have the federal structure of the United States, in matters of national security, financial security, and intelligence, it is necessary to ensure

<sup>188</sup> *Ibid.*, 204.

<sup>189</sup> Interview by Alexander Georgieff with William Partlett, December 7, 2012.

accountability for all member states. In the EU, the weakness of enforcing the federal standards has allowed money to pass easily through FIs.

Ultimately it is the national government's role to ensure that banks are compliant with money laundering laws, and are acting as effective regulators. However, due to either corruption, lack of effort or resources, national governments are failing to effectively implement the laws dictated by the EU Directive. What has been created, especially in economically small countries, are weak channels through which money can enter the EU. Once in the EU, the illicit capital passes freely from one EU bank to another, aided by loose correspondent banking laws. In other words, the EU is trying to be financially more like the U.S. in terms of laws, but lacks the federal oversight to ensure that this system can function safely.

The EU must ensure that all governments have well-functioning and active FIUs. OLAF seems like the most likely candidate for ensuring FIU monitoring. Their role should be as inspectors, pursuing frequent investigations of FIUs and placing pressure on national governments to blacklist non-compliant FIs.

However, blacklisting must go beyond merely isolating the bank. The EU should provide training and expertise, funded by the fines imposed, to efficiently reform the bank and liquidate criminal assets. While fines are effective in the short term, if governments are going to let these banks continue to operate, merely imposing fines often fails to address the underlying problem and increases the capacity of the institutions to protect themselves. Evidence suggests that crime networks buy-off and bribe banks and their lawyers, which means an emphasis must be placed on severing these connections. The EU must take charge in order to safeguard true compliance and reform; if banks are merely left on their own in this crucial process, there is a high risk of merely cosmetic reform.

Not only does illicit capital pose problems for financial institutions, including reduced confidence, but it also increases the costs of investigations to remedy the criminal presence. While some are opposed to increased EU spending at such a time, these policies will save the EU long-term costs associated with criminal infiltration.

It should be borne in mind that the deeper illicit money is layered into the EU financial system, the more difficult and expensive it is to locate and confiscate. Thus, all member states have an incentive to stop the money at the border. The eastern EU border-states are failing in their

role as financial gatekeepers, enabling an increased wave of crime. Money laundering will only increase if the EU does not take collective and clear-eyed action, targeting and reforming FIUs and blacklisted banks.

The current state of money laundering exists because ineffective accountability remains. While money laundering will inevitably occur, the cases of ROC groups laundering money into the EU are too frequent and blatant to ignore. We must assess their channels, especially through the eastern border countries, and through a joint EU effort, create an uncorrupt federal system that ensures regulation in all member states.

## About the Authors

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Alexander Georgieff holds an MPhil in Russian and Eastern European Studies from the University of Oxford, where he completed a thesis on the development of anti-corruption and money laundering agencies in Eastern Europe. Georgieff worked at the Institute for Security and Development Policy in the fall of 2012, where he concentrated on transnational illicit networks, in particular money laundering. He is currently a research associate at the Stimson Center in Washington, D.C., supporting U.S. efforts to combat transnational threats, including international terrorism and crime.